

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554**

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| In the Matter of |) | |
| |) | |
| Special Access Rates for Price Cap |) | WC Docket No. 05-25 |
| Local Exchange Carriers |) | |
| |) | |
| AT&T Corp. Petition for Rulemaking to Reform |) | |
| Regulation of Incumbent Local Exchange Carrier |) | RM-10593 |
| Rates for Interstate Special Access Services |) | |

**REPLY COMMENTS OF
ATX COMMUNICATIONS SERVICES, INC.
BRIDGECOM INTERNATIONAL, INC.
BROADVIEW NETWORKS, INC.
PAC-WEST TELECOMM, INC.
US LEC CORP.
U.S. TELEPACIFIC CORP. D/B/A TELEPACIFIC COMMUNICATIONS**

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| Attachment A | T. Randolph Beard, George S. Ford, & Lawrence J. Spiwak, Phoenix Center Policy Paper Number 20: Quantity-Discount Contracts as a Barrier to Entry, at 2 (Nov. 2004) ("Phoenix Policy Paper No. 20") |
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TABLE OF FREQUENTLY USED SHORT CITATIONS

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| Verizon | <i>Verizon Communications, Inc. v. FCC</i> , 535 U.S. 467 (2002) |
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| <i>TRRO or Triennial Review Remand Order</i> | <i>In the Matter of Unbundled Access to Network Elements Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers</i> , WC Docket No. 04-313, CC Docket No. 01-338, Order on Remand, 19 FCC Rcd 16783, FCC 04-290 (rel. Feb. 4, 2005) |
| <i>NPRM</i> | <i>Special Access Rates for Price Cap Local Exchange Carriers; AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services</i> , WC Docket No. 05-25, RM-10593, Order and Notice of Proposed Rulemaking, 20 FCC Rcd 1994, FCC 05-18 (rel. Jan. 31, 2005). |
| <i>TRO</i> | <i>Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Deployment of Wireline Services Offering Advanced Telecommunications Capability</i> , CC Docket Nos. 01-338, 96-98, 98-147, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, 18 FCC Rcd 16978 (2003), corrected by Errata, 18 FCC Rcd 19020 (2003) (subsequent history omitted) |
| <i>CALLS Order</i> | <i>Access Charge Reform</i> , CC Docket Nos. 96-262, 94-1, 99-249, 96-45, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962 (2000) (subsequent history omitted) |

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| <i>Pricing Flexibility Order</i> | <i>Access Charge Reform</i> , CC Docket No. 92-262, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd 14221 (1999) (subsequent history omitted) |
| <i>1997 Price Cap Review Order</i> | <i>Price Cap Performance Review for Local Exchange Carriers</i> , Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, 12 FCC Rcd 16642 (1997) (subsequent history omitted) |
| <i>Access Charge Reform Order</i> | <i>Access Charge Reform</i> , CC Docket Nos. 96-262, 94-1, 91-213, 95-72, First Report and Order, 12 FCC Rcd 15982 (1997) (subsequent history omitted). |
| <i>Local Competition Order</i> | <i>Implementation of the Local Competition Provisions of the Telecommunications Act of 1996</i> , CC Docket No 96-98, First Report and Order 11 FCC Rcd 15499 (1996) (subsequent history omitted) |
| <i>LEC Price Cap Order</i> | <i>Policy and Rules Concerning Rates for Dominant Carriers</i> , CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786 (1990) (subsequent history omitted) |

Ex Parte and Other Filings

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| Declaration of Lee Selwyn (dated Nov. 8, 2004) (filed in RM-10593 Dec. 7, 2004) | Letter from David L Lawson, Counsel for AT&T, to Marlene H. Dortch, Secretary, RM 10593 (attaching, inter alia, "Letter from C. Frederick Beckner III to Marlene H. Dortch, dated November 8, 2004 (with ex parte Declaration of Lee Selwyn)") (filed Dec. 7, 2004) |
| Reply Declaration of Lee Selwyn (dated Oct. 19, 2004) (filed in RM-10593 Dec. 7, 2004) | Letter from David L Lawson, Counsel for AT&T, to Marlene H. Dortch, Secretary, RM 10593 (attaching, inter alia, "Reply Declaration of Lee Selwyn (October 19, 2004)") (filed Dec. 7, 2004) |
| Reply Declaration of M. Joseph Stith (dated Oct. 19, 2004) (filed in RM-10593 Dec. 7, 2004) | Letter from David L Lawson, Counsel for AT&T, to Marlene H. Dortch, Secretary, RM 10593 (attaching, inter alia, "Reply Declaration of M. Joseph Stith (October 19, 2004)") (filed in RM-10593 Dec. 7, 2004) |
| Declaration of M. Joseph Stith (dated Oct. 4, 2004) (filed in RM-10593 Dec. 7, 2004) | Letter from David L Lawson, Counsel for AT&T, to Marlene H. Dortch, Secretary, RM 10593 (attaching, inter alia, "Declaration of M. Joseph |

**Reply Comments of ATX, BridgeCom, Broadview
 Pac-West, US LEC, U.S. Telepacific
 WC Docket No. 05-25, RM-10593
 July 29, 2005**

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| | Stith (October 4, 2004)”) (filed in RM-10593 Dec. 7, 2004) |
| ETI White Paper | Letter from Colleen Boothby, Counsel for Ad Hoc Telecommunications Users Committee, to Marlene H. Dortch, Sec’y, Federal Communications Commission, RM-10593, Att. (Economics and Technology, Inc., Competition in Access Markets: Reality or Illusion – A Proposal for Regulating Uncertain Markets) (filed Aug. 26, 2004). |
| Set It and Forget It? Market Power and the Consequences of Premature Deregulation in Telecommunications Markets | Letter from Brian R. Moir, counsel for the Special Access Reform Coalition, to Marlene H. Dortch, Sec’y, Federal Communications Commission, Attach. Phoenix Center Policy Paper Number 18 (George S. Ford & Lawrence J. Spiwak, Set It and Forget It? Market Power and the Consequences of Premature Deregulation in Telecommunications Markets (2003)) (filed July 18, 2003) |

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ATX Communications Services, Inc., BridgeCom International, Inc., Broadview Networks, Inc., Pac-West Telecomm, Inc., US LEC Corp, and U.S. Telepacific Corp. d/b/a Telepacific Communications (“Joint CLECs”) submit these reply comments in the above-captioned proceeding concerning reform of regulation governing pricing for interstate special access services provided by incumbent local exchange carriers subject to price cap regulation.¹

¹ *Special Access Rates for Price Cap Local Exchange Carriers; AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services, Notice of Proposed Rulemaking*, WC Docket No. 05-25 and RM-10593, FCC 05-18, released January 31, 2005 (“NPRM”).

INTRODUCTION AND SUMMARY

Not surprisingly, the BOCs submit that the special access marketplace is competitive and that the Commission should continue on its deregulatory path. Verizon goes so far as to claim that the “Commission’s progressive deregulation of special access rates has been a regulatory and marketplace success story.”² Although this may be so for Verizon and other BOCs (who are obviously the beneficiaries under the current regulatory scheme which includes the CALLS plan and the Pricing Flexibility rules), it has been no such thing for ratepayers. In fact, while the Commission had the best intentions (based on its predictive judgment) when it chose to take a hands-off approach to special access pricing, its policy has been a failure and ratepayers have been exploited as a result. Basically, competition is not strong, pervasive, or ubiquitous enough to reduce BOCs’ special access pricing to competitive levels. Rather, it is the exact opposite and as a result, BOCs are able to constrain competition (to the extent it exists) and are gaining ever increasing market power and dominance over the special access market.

Contrary to the BOCs’ claims, pricing flexibility and the CALLS plan have failed to produce the competitive rates for special access services that the Commission had hoped for. Substantial evidence in the record demonstrates that the BOCs’ special access rates are not at levels that would exist if the marketplace were competitive. A clear indication of this is the fact that the BOCs special access rates are dramatically higher than the forward-looking cost-based rates (*i.e.*, TELRIC-based rates) for comparable UNE services and the actual rates for comparable services offered by competitors.

² Verizon Comments at 1.

ARMIS data also reveals that BOCs are enjoying extraordinary and ever increasing rates of return on special access services. This confirms that BOCs can increase rates without fear of losing market share. Although BOCs contend that ARMIS data is flawed and unreliable, their arguments lack credibility because they embrace such data when it benefits them and despite being requested by the Commission, refused to recalculate their rates of return based on their criticisms of the data. Given this, it is quite possible that they are experiencing rates of return that are even higher than the ARMIS data reveals and wish not to disclose that fact. Basically, ARMIS data continues to provide a reliable indicator that the BOCs' special access prices are unreasonable and that there is a lack of viable competitive alternatives in the special access market.

It is unequivocal that BOCs have dominant market power given the substantial and sustained special access price increases. Indeed, where they have received special access pricing flexibility, substantial evidence demonstrates that their rates for DS1 and DS3 special access services have predominantly increased. Some of the BOCs concede this point with respect to month-to-month special access rates. Verizon argues otherwise based on a contrived comparison of special access revenues (not prices) per voice grade equivalent channel; however, its analysis is flawed and specious because it cannot disprove the fact that a direct apples-to-apples comparison of Verizon's actual special access prices at various points in time where it has pricing flexibility have increased by in large. The BOCs also argue that special access per unit revenues (not prices *per se*) have declined because more customers have entered into volume and term commitments. Although this may be so, customers are only entering into such agreements to minimize the impact of the increasing rates.

The record further demonstrates that the special access market is not competitive which confirms what the above evidence proves. Currently, there are almost no viable inter or intra-modal competitive alternatives to BOC special access services. Consequently, BOCs control 95 percent of the special access market. In addition, to the extent any competition exists, the BOCs constrain and deter it by locking their customers into volume and terms commitments. To make matters worse, the proposed mergers of SBC and Verizon with AT&T and MCI, the largest buyers and wholesale sellers of special access services, will, if approved, eliminate competition for special access services and enable these BOCs to further inflate their special access rates and implement a price squeeze in other markets.

For these reasons, the Commission should reinitialize special access rates to reflect the cost-based level that would be available if the special access marketplace were competitive. Contrary to the BOCs arguments, reinitializing rates is appropriate because the BOCs' continued dominance of the special access market renders the market unable to constrain the BOCs' special access prices.

Along with reinitializing rates, the Commission should overhaul the regulatory construct for special access pricing. Under the price cap framework, the X-factor should be imposed because hard data, which includes the percentages from the Bureau of Labor Statistics, demonstrates that productivity of the wireline telecommunications industry continues to outpace the economy as a whole. Sharing should also be reinstituted because if the marketplace were as competitive as the BOCs' claim, they would never earn such windfall profits. In addition, the Commission should establish separate baskets for DS1, DS3, OCn, mass market broadband and DSL, and retail special access along with the specific DS1 and DS3 categories Joint CLECs proposed. The proposals made by the BOCs to revamp the special access basket and category

structure should be rejected out of hand because they fail to establish appropriate and sufficient mechanisms needed to minimize anticompetitive cross subsidizations. Instead, their proposals would invite BOCs to offset rate reductions where there is competition with rate hikes between and among the various categories where there is none.

Next, the Commission should abolish or tighten Phase II pricing flexibility. Contrary to the BOCs' request, the Commission should not provide further Phase II pricing flexibility because substantial evidence strongly indicates that BOCs enjoy unconscionable earnings and are raising prices. Further regulatory relief would only lead to further abuses by incumbents.

If the Commission does not abolish Phase II pricing flexibility altogether, it should (at a minimum) significantly tighten Phase II pricing flexibility so that it applies at the wire center rather than the MSA level for interoffice mileage. Taking this approach is appropriate because transport alternatives occur in the marketplace on a route-by-route basis, not MSA wide. As to channel terminations, pricing flexibility should only apply on a building specific basis. Unlike transport, a wire center approach is not suitable for Phase II pricing flexibility of channel terminations because competitive alternatives for loops only occurs on a building-specific basis. Indeed, the existence of competition to serve one building does not mean that competitive alternatives are, or could be, available to other buildings in an MSA or served by the same wire center for any number of reasons, including different revenue opportunities based on the types of customers in each buildings, and different loop construction costs. Although the Commission did not adopt a building specific test in the *TRRO*, it did not do so because the D.C. Circuit in *USTA II* required it to consider potential competition in fashioning a revised test. In this proceeding, the Commission is under no direction to consider potential competition. Thus, under

any Phase II pricing flexibility construct the focus should be solely on whether actual competitive alternatives exist to constrain BOC prices.

The Commission should also find that the BOCs' exclusionary contracts are anticompetitive. Substantial evidence demonstrates that the BOCs are engaging in a strategy of establishing unreasonable month-to-month prices for special access services and then offering "discounts" only when customers agree to anticompetitive terms and conditions. One approach that may address this problem, in part, involves reinitializing month-to-month special access rates at UNE rate levels, which are TELRIC-based, as Joint CLECs recommend.

Finally, and although Qwest urges otherwise, the Commission must complete this proceeding before taking any action on the proposed mergers of SBC with AT&T and of Verizon and MCI, not the reverse. While Joint CLECs agree that the proposed mergers will harm competition, it would be a serious mistake for the Commission to grant the merger applications to any extent prior to revising its special access rules in way that can help assure all BOCs will be unable to continue to impose unreasonable special access pricing and anticompetitive conditions. Qwest is apparently hoping that the Commission will impose a few narrow conditions on SBC and Verizon and then oppose any serious reform of special access regulation in this proceeding.

**I CONTRARY TO THE BOCS' CLAIMS, PRICING FLEXIBILITY AND THE
CALLS PLAN HAVE FAILED TO PRODUCE COMPETITIVE SPECIAL
ACCESS PRICES**

**A. The BOCs' Special Access Rates Are Not At Levels That Would Exist In A
Competitive Market Because They Are Dramatically Higher Than The Cost-
Based Rates For Comparable UNE Services And Rates Offered By
Competitors**

As explained in Joint CLECs' initial comments, the Commission's predictive judgment that competition would by now have forced special access prices closer to the Commission's goal of forward looking economic costs was erroneous.³ Joint CLECs demonstrated that the BOCs' special access rates far exceed TELRIC-based rates for functionally equivalent DS1 and DS3 services that would exist if the marketplace were truly competitive. Evidence submitted by commenting parties further proves this.

For example, T-Mobile compared the prices for special access DS1 channel terminations (based on a 36 month term) to the prices for DS1 UNE loops in Florida, Illinois, New York, Texas, and Washington and found that the BOCs' special access rates are 125.25, 367.97, 160.20, 145.61, and 148.90 percent more than UNE rates, respectively.⁴ The comparison between special access and UNE prices for DS1 and DS3 channel mileage reveals similar, and in

³ Joint CLECs Comments at 5.

⁴ T-Mobile Comments, Declaration of Simon J. Wilkie, ¶ 19, Appendix 2, at 1. T-Mobile also compared the prices for 10 mile special access DS1 channel mileage/interoffice circuits (based on a 36 month term) to the prices for comparable UNE circuits in Florida, Illinois, New York, Texas, and Washington and found that special access rates are 131.79, 463.35, 238.15, 387.76, and 364.71 percent more than UNE rates for functionally equivalent services. *Id.*, Appendix 2, at 2. In addition, T-Mobile compared the prices for 10-mile special access DS3 channel mileage/interoffice circuits (based on a 36 month term) to the prices for DS3 Channel Mileage in these states and found that Special access rates are 128.30, 179.76, 210.51, 227.39, and 190.08 percent more than UNE rates, respectively. *Id.*, Appendix 2, at 3.

many cases greater disparities, especially when comparing channel mileage rates on a per mile basis.⁵

Moreover, when actual rates offered by competitors are compared to the BOCs' special access rates, the same holds true and the disparity is even more pronounced. Dr. Simon J. Wilkie explains in his declaration that the best means of assessing whether special access prices are competitive would be to compare those prices with data from "benchmark" competitive markets to determine whether the special access prices are above or below the competitive benchmark.⁶

For transport services, ILEC interstate special access rates were compared with the competitive prices for similar transport rates between cities where there are several competitors with their own facilities.⁷ Dr. Wilkie's analysis reveals that "the cost of a 10 mile Verizon special access DS3 circuit in New York is \$1,817.12, or over 100 times more than the \$14.00 per mile price of a circuit of the same length along the New York-Los Angeles route."⁸ Given this incredible disparity, Dr. Wilkie observes that,

if a firm could readily enter the New York area to provide competing transport services along routes where the prevailing prices are 50 to 100 times the prices for comparable services in a competitive market, then such entry almost certainly would have already occurred and the price discrepancies would have disappeared. This entry has not happened, leading us again to the conclusion that the

⁵ For instance, the per mile DS1 special access channel mileage/interoffice transport rates are 3500.00, 2640.09, 1307.69, 704.79, and 701.46 *percent higher* than the comparable per mile UNE rates in Texas, Florida, Washington, Illinois, and New York, respectively. *Id.*, Appendix 2, at 2. The per mile DS3 special access channel mileage/interoffice transport rates are 1208.01, 779.75, 699.68, 303.90, and 184.50 percent higher than the comparable per mile UNE rates in Florida, New York, Texas, Washington, and Illinois, respectively. T-Mobile Comments, Declaration of Simon J. Wilkie, 19, Appendix 2, at 3.

⁶ T-Mobile Comments, Declaration of Simon J. Wilkie, ¶ 10.

⁷ *Id.*, ¶ 11.

⁸ *Id.*, ¶ 13.

combination of sunk costs and smaller size of the market for the short-haul links are barriers to entry that make entry uneconomic.⁹

Dr. Wilkie further explains that taking into account the economies of scale associated with distance, the special access price in every market analyzed ranges from two to six times the estimated competitive price.¹⁰ Additional record evidence supports this finding. Specifically, the Declaration of Janet S. Fischer examines the gap between BOC pricing and competitive pricing and shows that the competitors rates are often one-half to one-third of the BOCs' special access rates.¹¹

The Commission previously explained it expected that by now it would "have additional regulatory tools by which to assess the reasonableness of access charges."¹² For instance, the Commission stressed that it may "*establish benchmarks based on prices for the interstate access services for which competition has emerged, and use prices actually charged in competitive markets to set rates for non-competitive services or markets*"¹³ Another approach is to use UNE rates as benchmarks since they reflect the prices that would be assessed in a competitive marketplace. These benchmarks are now available and they demonstrate that the BOCs' special access rates are not reasonable.

As the above comparisons and those in the Stith Declaration (as presented in Joint CLECs' comments) reveal, BOCs' special access prices rates are entirely unreasonable because

⁹ *Id.*, ¶ 14.

¹⁰ *Id.*, ¶ 18.

¹¹ CompTel/ALTS *et al.* Comments, Declaration of Janet S. Fisher, ¶ 9.

¹² *Access Charge Reform Order*, ¶ 268.

¹³ *Id.*, ¶ 268 (emphasis added).

they far exceed those that would be charged in a competitive market. In addition, the above comparisons reveal that UNE rates do approximate competitive prices. Indeed, in the limited circumstances where the marketplace is truly competitive, the above evidence reveals that the competitors' rates are comparable to, if not less than, UNE rates. Thus, to the extent the Commission does not have competitors' rates against which to evaluate BOC rates, it can confidently rely on the UNE benchmark comparison to find that special access rates are unreasonable and far exceed economic costs.

B. ARMIS Data Provides Substantial Evidence That The BOCs Are Exercising Market Power And Enjoying Increasing Monopoly Profits and Returns

As explained in Joint CLECs' comments, the BOCs' extraordinarily high special access rates of return further demonstrate that the Commission's regulatory framework governing special access pricing is not producing just and reasonable rates and that BOCs retain market power over special access services. As expected, the BOCs argue that ARMIS rate of return data is flawed and unreliable. They contend that it should not be used to assess the BOCs' market power or for ratemaking purposes.¹⁴ For the reasons explained below, the BOCs' criticisms can be rejected readily.

First, the BOCs have embraced ARMIS data when it benefits them. As explained in the Ad Hoc Users Comments, the BOCs in other contexts have stressed the value and utility of ARMIS data for ratemaking purposes.¹⁵ Indeed, the BOCs are quick to dismiss ARMIS data when it demonstrates that they are over-earning, but they nonetheless are happy to offer it to

¹⁴ Verizon Comments at 17; SBC Comments at 24; BellSouth Comments at 8; Qwest Comments at 10.

¹⁵ Ad Hoc Users Comments at 29.

regulators as showing that UNE prices are too low.¹⁶ Further, the BOCs' contentions that misallocations of costs to the Common Line category inflates ARMIS-based rates of return strains credulity because in other settings, they have explicitly admitted that special access costs are not being misallocated to that category.¹⁷ As the Ad Hoc Users explained, the "Commission cannot ignore ARMIS earnings data on the basis of irreconcilable and self-serving claims that ARMIS is (1) reliable for determining the cost of a single disaggregated service element but (2) unreliable for calculating the aggregate (and excessive) rate of return for the entire special access category."¹⁸ In any event, the evidence demonstrates that even if there are any misallocations, it is more likely that costs from other ILEC services are being improperly assigned to special access.¹⁹

Second, despite the BOCs' misallocation arguments, the Commission invited the BOCs to re-run the numbers by (1) "remov[ing] from the BOCs' interstate special access operating expenses and average investment data reported in ARMIS any expenses and investments that are not directly assignable;" and (2) "calculat[ing] the compound annual growth rates for BOC

¹⁶ *Id.* at 29-30.

¹⁷ *Id.* at 30.

¹⁸ *Id.* at 31; ETI White Paper at 32-33.

¹⁹ ETI White Paper at 33. ETI explained that for 2003, the new investment allocated to the special access category for the four BOCs was roughly one third of their total interstate net investment and approximately 40% of their combined Common Line and Special Access Investment categories. *Id.* ETI noted that because there are fewer than 4-million special access loops and associated interoffice transport facilities, compared to more than 158-million Common Line local service loops in the BOCs' operating territories, the allocated investment is entirely disproportionate to the number of special access loops, as a percentage of total loops in service. *Id.* Thus, the wide discrepancy between the number of loops used for special access and the amount of interstate investment assigned to those loops certainly raises suspicions that costs are being over-allocated to the special access category. *Id.*

interstate special access operating expenses and average investment using these adjusted data.”²⁰

Rather than re-calculating the ARMIS rates of return, the BOCs instead, throw up a smoke screen by casting aspersions on the ARMIS data itself. Their actions are highly dubious because the BOCs have the means to readily estimate what their rates of return would be based on their challenges and criticisms about the allocations. Absent such re-calculations, there should be a presumption that they are unable to controvert ARMIS rates of return and that they are likely experiencing profits that equal or exceed such levels.

The re-calculations requested by the Commission would also reveal a relationship with demand growth and growth in expenses and investment that “suggest [] that BOCs realized scale economies.”²¹ As CompTel/ALTS explained, because the BOCs can meet ever-increasing demand for their special access services on an incremental cost basis, the failure of the BOCs to flow through their economies of scale to the consumer and carrier market has led to excessive rates of return.²² “In a competitive market, or even under the Commission’s previous price cap rules, such efficiency gains would be passed along to the consumer in the form of lower prices.”²³ However, as demonstrated, the BOCs have increased prices or kept them the same where they have been granted pricing flexibility.

Third, contrary to the BOCs’ claims that the separations freeze exacerbates the inaccuracy of what can be concluded from ARMIS data, a review of the BOCs’ total interstate

²⁰ *NPRM*, ¶ 29.

²¹ *Id.*, ¶ 29.

²² CompTel/ALTS *et al.* Comments at 6.

²³ *Id.* at 6.

earnings reveals that even if costs are being misallocated, BOCs are still experiencing phenomenal interstate rates of return overall. For instance, BellSouth's, Qwest's, SBC's, and Verizon's total interstate returns for 2004 were 20.30, 28.72, 22.17. and 15.89 percent, respectively.²⁴ These rates-of-return are well above the Commission's prescribed 11.25 percent rate of return "benchmark for determining whether price cap LECs' special access rates are just and reasonable."²⁵ Moreover, the fact that the 11.25 percent rate of return is outdated and should be in the 8 percent range²⁶ further proves that the BOCs' earnings are excessive by any standard. Indeed, these earning are nearly two to over three times that amount across the board.²⁷ The Commission must recognize that where there is smoke there is fire and in this case, plumes of excessive earnings have been ignited and fueled by the BOCs excessive and unreasonable special access rates.

Fourth, even if ARMIS rates-of-return are not ideal due to the alleged misallocations noted by the BOCs, that,

does not affect the overall integrity of *trends* in the data, *since those (arguable) misallocations do not change from period to period*. In other words, even if the absolute rate of return developed for the special access category using ARMIS data is off by some percentage, the trend in the data (in this case steadily up) should nevertheless be a reliable indicator of the BOCs' ability to increase prices to supracompetitive levels without fear of attracting competitive entry.²⁸

²⁴ ARMIS Report 43-01, Table I, Column (h), Row 1915/Row 1910; *see also* SBC Comments, Declaration of David Toti, Attachment 7.

²⁵ *NPRM*, ¶ 60.

²⁶ Joint CLECs Comments at 24.

²⁷ *See also* Ad Hoc Users Comments at 41-42.

²⁸ ETI White Paper at 29.

For all these reasons, ARMIS data continues to be a reliable indicator that BOC special access prices are unreasonable and reflect the lack of competitive alternatives in the vast majority of situations.

C. Pricing Flexibility Has Resulted In Substantial And Sustained Special Access Price Increases

The Commission recognizes that the level of competition in a market can be determined based on whether there has been substantial and sustained price increases.²⁹ In their initial comments, Joint CLECs demonstrated that the BOCs continue to possess market power in the provision of special access because they have maintained or raised their DS1 and DS3 special access rates when given pricing flexibility and have been able to both retain customers and increase sales in the wake of rising prices.³⁰

In its initial comments, BellSouth does not contest the fact that its month-to-month prices for DS1 and DS3 special access services have increased and concedes that these tariffed rates have gone up by 8 to 9 percent.³¹ Further, SBC does not dispute the fact that its Phase II basic tariff rates are higher than those in price cap MSAs.³² SBC asserts that this is due to the X-factor reductions to price cap rates that are mandated by the Commission's rules which do not apply to services subject to Phase II pricing flexibility.³³ BellSouth further avers that its DS1 24 month or

²⁹ *NPRM*, ¶ 73.

³⁰ Joint CLECs Comments at 10-13.

³¹ BellSouth Comments at 14-16.

³² SBC Comments, Castro Declaration, n.49.

³³ *Id.*

longer term commitment rates have remained constant over the past four years.³⁴ However, as previously explained in Joint CLECs' comments,³⁵ to the extent BOCs have not increased their special access rates and have kept them at pre-pricing flexibility levels, the fact that BOCs are maintaining such rate levels is "tantamount to a price *increase* in light of the declining costs of special access service...."³⁶

Notably, the Commission recognizes that "a substantial price increase need not be a large increase" but can be a "small but significant non-transitory price increase in the relevant product market."³⁷ In this proceeding, the record reveals that BOCs possess market power because when a steady and substantial reduction in the cost of providing service continues over a period of years is not reflected in a reduction in the prices for those services, the level of competition in the market is patently insufficient to overcome such market power and prevent the BOCs from maintaining or increasing their rates.³⁸

Verizon contends that prices have not increased because increased special access revenues are the result of increasing demand rather than increasing prices and that, in reality, revenues per line have been decreasing. This claim, however, is flagrantly misleading and a transparent attempt to avoid a specific price comparison. Dr. Taylor's declaration provides an analysis of the average revenue per voice grade equivalent ("VGE") over the entire 1996-2004

³⁴ BellSouth Comments at 17.

³⁵ Joint CLECs Comments at 11.

³⁶ Reply Declaration of M. Joseph Stith (dated Oct. 19, 2004) (filed in RM-10593 Dec. 7, 2004), ¶ 17.

³⁷ *NPRM*, n.188.

³⁸ See Ad Hoc Users Comments at 25.

period as well as one that has been bifurcated into two segments, representing the so-called price cap period (1996-2001) and pricing flexibility period (2001-2004).³⁹ He asserts that when DSL revenues are removed from total special access category revenues, the average revenue per VGE fell faster than required by the price cap index and faster during the pricing flexibility period.⁴⁰

Dr. Taylor's analysis is faulty for numerous reasons and if anything, proves that "Verizon has raised its prices in pricing flexibility areas."⁴¹ Dr. Taylor's claim that special access prices have been decreasing was not based upon analysis of specific prices and price changes over time, but instead was created from a contrived comparison of "average revenue per voice grade equivalent" channel.⁴² "Special access services are not priced or sold in terms of 'average revenue per VGE,' but instead denominated in terms of multiple pricing dimensions... including, among other things, bandwidth (capacity) and distance."⁴³ As AT&T's witness Lee Selwyn previously demonstrated in the Triennial Review Remand Proceeding, Dr. Taylor's analysis is flawed for numerous reasons⁴⁴ and inherently specious because if, as Verizon claims, its special access prices have been dropping since the onset of pricing flexibility, it should have been able to show that via a direct like-for-like comparison of actual tariff prices at various points in time, rather than by means of the indirect – and inaccurate – device of an average revenue per VGE

³⁹ Declaration of William E. Taylor, ¶ 16.

⁴⁰ *Id.*

⁴¹ Declaration of Lee Selwyn (dated Nov. 8, 2004) (filed in RM-10593 Dec. 7, 2004) at 5.

⁴² *Id.* at 8.

⁴³ *Id.* at 9.

⁴⁴ See Declaration of Lee Selwyn (dated Nov. 8, 2004) (filed in RM-10593 Dec. 7, 2004) at 3-16; Reply Declaration of Lee Selwyn (dated Oct. 19, 2004) (filed in RM-10593 Dec. 7, 2004) at 47-75.

surrogate.⁴⁵ Of course, that type of comparison would disprove Verizon's claim, so it is hardly surprising that Dr. Taylor needed to devise this "smoke and mirrors" approach to "proving" what is in fact not true.⁴⁶

SBC, BellSouth, and Verizon also claim that their average special access prices or revenues for DS1 and DS3 services have generally declined and explain that these reductions stem from the increasing number of customers entering into volume and term commitments.⁴⁷ Verizon maintains that the actual rates the customers must pay (not the list prices) are the appropriate starting point for any pricing analysis.⁴⁸ Besides amounting to an apparent admission that their non-discounted prices have risen, substantial evidence in the record shows that BOCs' "actual" special access prices have generally risen across the board. (Nor as noted, have BOCs submitted a simple price comparison that could have verified their claim that so-called discounted prices have declined.)

Specifically, Sprint reports that special access rates charged by BOCs with Phase II pricing flexibility have increased or remained flat.⁴⁹ It submits that the rates in most instances are significantly higher than (sometimes more than double) the rates charged for the same services under price cap regulation. Significantly, *Sprint estimates that its 2004 access charge*

⁴⁵ Declaration of Lee Selwyn (dated Nov. 8, 2004) (filed in RM-10593 Dec. 7, 2004) at 8.

⁴⁶ *Id.*

⁴⁷ SBC Comments at 21; BellSouth Comments at 19-20; Verizon at 22, Declaration of William E. Taylor, ¶¶ 26 & 41.

⁴⁸ Verizon Comments at 22.

⁴⁹ Sprint Comments at 5.

*cost was approximately \$103 million higher under the current price flexibility regime than it would have been had those services been available at price cap rates.*⁵⁰

Global Crossing reports that special access prices in pricing flexibility areas consistently exceed price cap rates for the same services. For example, DS1 channel terminations are 22 to 47 percent higher in Qwest pricing flexibility areas than under Qwest's price caps and DS1 mileage rates are 13 to 71 percent higher in BellSouth pricing flexibility areas than under BellSouth's price caps.⁵¹ The Phoenix Center also concluded that the BOCs increased their DS1 and DS3 rates where they had pricing flexibility.⁵² Ad Hoc Users Committee and two of the Commission's industry economists confirm that BellSouth, Qwest, SBC and Verizon raised special access rates in such instances as well.⁵³

Moreover, the Declaration of Mr. Stith reveals that for a 10-mile and 0-mile circuit the BOCs' tariffed month-to-month and Optional Pricing Plan ("OPP") rates for DS1 and DS3 subject to pricing flexibility are generally greater than corresponding price cap rates.⁵⁴ When evaluating the differences between 2001 and 2004 (pre and post-pricing flexibility) rates, Mr.

⁵⁰ Sprint Comments at 5.

⁵¹ CompTel/ALTS *et al.* Comments at 7, Declaration of Janet S. Fisher, ¶ 5 & Table 1.

⁵² Set it and Forget it? Market Power and the Consequences of Premature Deregulation in the Telecommunications Markets, at Table 1.

⁵³ Ad Hoc Users Comments at 21, Attachment C; Noel D. Uri and Paul R. Zimmerman, Special Access Service and its Regulation in the United States, 6 Journal of Policy, Regulation, and Strategy for Telecommunications, 122-160 (2004); *see also* Letter from Brian R. Moir, SPARC Chairman, to Michael K. Powell, Chairman, FCC, RM Docket No. 10593 (Sep. 2, 2004).

⁵⁴ Declaration of M. Joseph Stith (dated Oct. 4, 2004) (filed in RM-10593 Dec. 7, 2004), ¶ 19, Attachment 1 at 1, & Attachment 2 at 1.

Stith consistently finds that 2004 rates are, on average, equal or greater than the 2001 rates. For example, Qwest's month-to-month pricing flexibility rates for a ten mile DS1 and DS3 are 25 and 56 percent higher, respectively, on average than what they were in 2001 under price caps.⁵⁵ For a 10-mile DS1 special access circuit, Verizon-South's, SBC's, Verizon-North's, and BellSouth's are 15, 13, 10, and 8 percent higher, respectively.⁵⁶ For Optional Pricing Plans ("OPPs"), BellSouth and SBC have left their pricing flexibility OPP rates exactly at the 2001 level – which, as discussed above is equivalent to a price increase.⁵⁷ Qwest raised its DS1 and DS3 OPPs by 13% and 42%, respectively, and Verizon-North increased its DS1 OPPs by 18%. The results for a zero-mile DS-1 circuit are similar.⁵⁸

Accordingly, initial comments provide substantial evidence that BOCs' special access prices have been increasing where they have pricing flexibility.

D. The Special Access Market Is Not Competitive

In a transparent effort to escape special access pricing regulation and safeguard the incredible returns they are raking in from overcharging their special access ratepayers, the BOCs submit that the marketplace is competitive and that the Commission should continue on its deregulatory path. Contrary to what the Commission had hoped would have occurred by now, competition is not strong, pervasive or ubiquitous enough to reduce the BOCs' special access pricing to competitive levels. Rather, it is the exact opposite. For the reasons discussed below,

⁵⁵ Reply Declaration of M. Joseph Stith (dated Oct. 19, 2004) (filed in RM-10593 Dec. 7, 2004), Attachment at 1 (attached to Ad Hoc Users Comments).

⁵⁶ *Id.*, ¶ 17.

⁵⁷ *Id.*, ¶ 17.

⁵⁸ *Id.*, ¶ 18.

BOCs are able to constrain competition (to the extent it exists) and are gaining ever increasing market power and dominance over the special access market.

1. Almost No Viable Competitive Alternatives To BOC Special Access Services Exists

USTA argues that “[t]here are many competitors in special access markets today,” such that it is “routine” for special access customers “to receive multiple offers to meet service requests.”⁵⁹ Similarly, Verizon maintains that “special access competition is robust and the marketplace is working.”⁶⁰ Verizon alleges that “competition exists virtually everywhere that there is significant demand for special access,” and this purported competition comes from “a multitude of sources, including fiber-based CLECs . . . and inter-modal alternatives such as fixed wireless and cable.”⁶¹ SBC also alleges that “competitors have built a myriad of alternative fiber facilities over which competitors are actively serving high-capacity special access customers” and there is “accelerating” intermodal competition.⁶²

In short, the BOCs contend that intramodal and intermodal competition is rampant in the market for special access services and is growing day by day, thereby obviating the need for any substantial change in the Commission’s pricing flexibility rules and justifying even complete deregulation of their special access offerings.⁶³ This self-serving rhetoric clearly does not comport with marketplace reality as observed not only by CLECs, wireless carriers and other

⁵⁹ USTA Comments at 8.

⁶⁰ Verizon Comments at 38.

⁶¹ Verizon Comments at 23.

⁶² SBC Comments at 11, Casto Declaration, ¶¶ 11, 16.

⁶³ *See, e.g.*, SBC Comments at 1-13 (“continued regulation . . . is not only unnecessary but also counterproductive”).

service providers but also by large consumers of telecommunications services who have no commercial self-interest in the matter and find they rarely have alternatives to ILEC special access services – especially channel terminations. Indeed, when it comes to the last mile facilities, due to the scarcity of competitive alternatives, the BOCs are still *de facto* monopoly providers. The cold reality is that alternatives to BOC special access services from intramodal and intermodal competitive providers rarely exist so that most carriers and customers must rely on BOC special access services for well over ninety (90%) of their needs.⁶⁴

Significantly, even where a competitive provider offers service on a portion of a route, the competitor frequently must obtain the channel terminations for the “last mile” to the customer premises on a resold basis from the ILEC which typically amounts to over half of the entire circuit cost.⁶⁵ As Broadwing observes, “[w]ith relatively few exceptions – predominantly owned by AT&T and MCI – the ILECs own the *only* last mile link to the target buildings and, therefore, anyone who wants to serve customers in those buildings must either purchase access from the ILEC or from another carrier reselling the ILEC’s services.”⁶⁶ USTA’s and Verizon’s arguments that special access customers receive multiple offers to meet service requests blatantly and misleadingly disregard this very fact.⁶⁷

⁶⁴ *AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, RM Docket No. 10593, Decl. of Kenneth Thomas, at 1 (Oct. 15, 2002) (“AT&T Decl. of Kenneth Thomas”); PAETEC Comments, at 6 (Even in “high-density markets” . . . “PAETEC is dependent on ILECs for 95 percent of its special access lines”).

⁶⁵ Sprint Comments at 6; Broadwing Comments at 11 (“the ILECs still maintain a near monopoly over the tails that connect an ILEC serving wire center to a customer premises”).

⁶⁶ Broadwing Comments at 14.

⁶⁷ USTA Comments at 8; Verizon Comments at 33.

Even AT&T, despite its ownership of one of the most extensive national networks (which may soon be controlled by an SBC), its large traffic volumes, superior resources and greater than average bargaining power, reluctantly has relied on the BOCs for the vast majority of its special access needs. AT&T reported in 2002 that it had facilities to only about 6,000 of the 3 million commercial buildings in the country – a mere one-fifth of one percent.⁶⁸ Further, AT&T acknowledged that it relied on ILEC last mile special access channel terminations 95% of the time in reaching commercial buildings and was able to utilize a CLEC alternative for only 2% of its needs.⁶⁹ U.S. Telepacific, a member of the Joint CLECs, similarly reports that on all its circuits to various buildings in San Diego, it relies wholly on PacBell for special access channel terminations because alternative providers are only available 4.5 percent of the time. MCI has a comparable dependence on ILEC special access circuits and estimates that 90% of its off-net special access circuits were provisioned by ILECs.⁷⁰

Statements by Sprint confirm the dearth of competitive alternatives to ILEC special access services. For instance, in 2002 Sprint stated that “Sprint Long Distance . . . continues to rely upon the ILECs for approximately 93% of its total special access needs despite aggressive attempts to self-supply and to switch to” CLEC-provided facilities “wherever feasible.”⁷¹ At the end of 2004, Sprint reports that it still “relied upon RBOCs for almost 95% of its DS1 circuits”

⁶⁸ AT&T Declaration of Kenneth Thomas, at 1.

⁶⁹ *Id.*

⁷⁰ *Performance Measures and Standards for Interstate Special Access*, CC Docket No. 01-321, Comments of WorldCom, Inc. Corporation, at 9-10 (Jan. 22, 2002); Broadwing Comments at 15.

⁷¹ *Performance Measures and Standards for Interstate Special Access*, CC Docket No. 01-321, Comments of Sprint Corporation, at 4 (Jan. 22, 2002); ETI White Paper, at 17-18.

despite concerted efforts to purchase services from competitive suppliers.⁷² AT&T further observes that alternative providers provide connectivity to no more than 2% of the commercial buildings in the country. Although this amount is in itself *de minimus*, it is an overstatement because a competitive provider's facilities are not always available throughout such buildings. This is so because they "are not always able to secure the building owner's permission to locate equipment in the building's common space, so that in many cases access is limited to a 'fiber to the floor' arrangement" such that only particular floors and customers can be served by CLEC facilities.⁷³ Sprint observes that in 40% of the buildings in which a competitive alternative exists, the CLEC can provide a connection to only a single customer and not to other customers located in the same building.⁷⁴

Consistent with the experience of the carriers notes above, the Ad Hoc Users have conservatively determined that in the special access market ILECs "remain the sole source of connectivity at roughly 98% of all business premises nationwide, even for [these] largest corporate users."⁷⁵ This is so even though the group members have greater bargaining power, demand for more widely available higher capacity circuits, and greater access to competitive offerings than small and mid-sized companies and other users.⁷⁶ The Ad Hoc Users calculate that even this figure is a "lower bound estimate" with the actual amount of commercial buildings

⁷² Sprint Comments at 7.

⁷³ ETI White Paper at 18, n.32.

⁷⁴ AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access, RM Docket No. 10593, Comments of Sprint Corporation, at 4 (Dec. 2, 2002).

⁷⁵ ETI White Paper at iv, 12, 16.

⁷⁶ *Id.* at iv, 12, 16.

that have no alternative to ILEC special access “likely higher.”⁷⁷ The Ad Hoc Users also note that “[e]ven where competitive alternatives are nominally ‘available’, members are able to make little use of those competitor services for a variety of reasons” including the fact that the competitor may not be as responsive because it must perform additional build-out, have lower reliability because it does not control the entire circuit, and other factors.⁷⁸

At bottom and contrary to Verizon’s allegation that “competition exists virtually everywhere,” the reality in the market place is that the current availability of competitive alternatives to BOC special access circuits is confined to a small number of office buildings, often limited to individual floors or customers, in a small number of concentrated business districts. Even where a competitive circuit is available, the last few miles or other portions may actually be comprised of resold ILEC circuits. This dependence on the ILEC for the last mile in the special access market makes competitive providers extremely vulnerable to exclusionary practices or a price squeeze as discussed below.

2. The BOCs Utilize Exclusionary Practices To Frustrate Competition Along Those Few Routes Where Competitive Facilities Exist And To Deter New Entrants

The limited scope of competitive special access offerings demonstrated above, combined with a plethora of exclusionary practices invented and implemented by the ILECs, makes it operationally difficult and often uneconomic for customers to take advantage of the meager supply of competitive offerings even in those rare instances where they exist. As many CLEC

⁷⁷ ETI White Paper at 17.

⁷⁸ *Id.* at 19-21.

comments submitted in this proceeding indicate,⁷⁹ ILECs often impose exclusionary contract terms such as high termination penalties and “take or pay” provisions to eliminate any nascent competition in the special access market.

The ILECs, for example, offer significant discounts on their exorbitant special access rates only to purchasers who enter into “take or pay” contracts to purchase a fixed monetary amount of special access services each month over an extensive term of one, three, or five years.⁸⁰ If a carrier chooses an alternative provider in the ILEC’s region for special access along one of the few routes where competition exists, then it incurs a substantial risk that its total spending on special access pursuant to its ILEC contract will fall below the required threshold with the result that the carrier must pay the shortfall to the ILEC.⁸¹ Thus, even if the competitive provider offers a much lower rate for a given route, carriers may not choose the service from the competitive carrier because of the adverse impact on the discounts offered under their volume and term ILEC contract upon which they must depend to reach the vast majority of their enterprise customers.⁸²

The ILECs also often “offer discounts on special access along routes where no competitive facilities are available on the condition that purchasers buy special access services along routes where competitive alternatives do exist.”⁸³ Further, ILECs typically lock-in

⁷⁹ See, e.g., WilTel Comments at 13-15; CompTel/ALTS Comments at 11-10; Broadwing Comments at 22-26.

⁸⁰ Broadwing Comments at 22-23.

⁸¹ *Id.* at 3-4, 22-23.

⁸² *Id.* at 3-4, 22-23.

⁸³ Broadwing Comments at 23-24.

customers through onerous termination penalties. For instance, ILECs impose such penalties on a circuit specific basis under 3 to 5 year contracts such that if a customer moves to a competitive provider's circuit, it must pay a substantial termination penalty relating to that circuit even if its overall purchase or revenue commitment with the ILEC remains the same or increases.⁸⁴ In contrast, competitors "offer greater circuit portability" and typically will not charge a termination penalty if the customer's overall spend rate remains above a committed level or the circuit has been in place for a relatively short term such as 12 months.⁸⁵

The disturbing reality is that because BOCs dominate the special access market, they have far more bargaining power than CLECs and therefore, are able to force CLECs into unconscionable take-it-or-leave-it adhesion agreements that contain these onerous termination penalties, long term commitments, and take or pay provisions. Because alternative providers lack such market power, they must offer more generous terms; however, the BOCs' anticompetitive terms makes it extremely cost prohibitive for customers to take advantage of such competitive alternatives.⁸⁶

The BOCs' exclusionary practices do not stop there. They also exploit their market power to ensure it is "administratively and financially difficult (in some cases, impossible) to efficiently migrate existing special access facilities to" a competitive provider.⁸⁷ For instance, "some RBOCs limit the quantities of circuits that can be migrated per night or by type or service,

⁸⁴ *Id.* at 26.

⁸⁵ *Id.* at 26-27.

⁸⁶ CompTel/ALTS *et al.* Comments at 11-20.

⁸⁷ Sprint Comments at 6.

or assess high non-recurring charges for coordinated service termination.”⁸⁸ Verizon, for example, imposes an exorbitant “\$380 Coordinated Retermination” NRC per channel termination.”⁸⁹ In contrast, the installation NRC for other services is only \$1 per channel.⁹⁰ Also, ILECs will not offer service level agreements (“SLAs”) on UNE loops and transport.⁹¹ As a result, competitive special access providers who rely on UNEs for components or segments of a special access service are unable to offer an SLA to customers which results in a loss of business.

In short and contrary to Verizon’s allegation that the “market place is working,” the record demonstrates that BOCs are protecting their special access market power by employing exclusionary practices that ensure that even in those rare instances where competitive facilities exist, it is uneconomic for its customers to use them.

3. Intermodal Competitive Alternatives From Cable and Fixed Wireless Providers Are Not Viable Alternatives for ILEC Special Access

Contrary to ILEC assertions of substantial competition in the special access market from cable companies and fixed wireless companies, these competitors have deployed non-wireline (*i.e.*, intermodal) alternatives to ILEC special access services at even fewer office buildings and other business locations than have intramodal competitive providers. In fact, the Commission was justifiably dismissive of the level of intermodal competition for enterprise customers in the *TRO* and commented that “while there was some fixed wireless entry in the enterprise market, it

⁸⁸ *Id.* at 6-7.

⁸⁹ *Id.* at 7 (citing to Tariff FCC No. 1, Section 7.5.9(a)(1)).

⁹⁰ Sprint Comments at 7.

⁹¹ Broadwing Comments at 18-19.

has been limited.”⁹² The Commission also recognized that cable modem service is primarily available to the residential market.⁹³ In the *TRRO*, the Commission’s review demonstrated that “cable companies predominantly compete in the mass market for broadband services” while in the enterprise market “such competition is evolving more slowly and in more limited geographic areas.”⁹⁴ The Commission concluded that the “record contains little evidence that cable companies are providing service at DS1 or higher capacities,” and in fact “suggests that most of the businesses served by cable companies are not large enterprise customers, but mass market small businesses that would never generate enough traffic to require a high-capacity loop.”⁹⁵

Moreover, “it is clear that intermodal providers are not capable of supplying a sufficient quantity or quality of service to represent a serious competitive choice” for large businesses or carriers.⁹⁶ While cable infrastructure reaches most residential dwellings, it generally does not pass business locations and is not readily available to the “vast majority of office buildings and other business sites.”⁹⁷ The Commission has acknowledged the limited scope of deployment by cable companies to business locations, finding that 96% of the high-speed connections provided by cable companies were for residential and small businesses, which is “consistent with our understanding that most cable systems are currently deployed primarily in residential areas.”⁹⁸

⁹² *TRO*, ¶ 45, n.144.

⁹³ *TRRO*, ¶¶ 39, 193.

⁹⁴ *TRRO*, ¶ 39.

⁹⁵ *TRRO*, ¶ 193.

⁹⁶ ETI White Paper at 22.

⁹⁷ *Id.* at 23.

⁹⁸ *Inquiry Concerning the Deployment of Advanced Telecommunications Capability*, CC Docket No. 98-146, Third Report, FCC No. 02-33, 17 FCC Rcd. 2844, at ¶ 45 (2002); *TRRO*, at

Further, because cable systems are engineered primarily to serve residential customers their telephony and data service products generally do not offer the high level of reliability, security, upstream data rates, and other capabilities that ILECs ubiquitously provide with their service offerings which large enterprise customers demand, especially for their sensitive data.⁹⁹ For example, due to engineering and architecture issues, cable systems do not meet telephone reliability standards and do not provide the same level of back-up power as a telephone system.¹⁰⁰ While telephone systems are powered from central offices and have battery back-up power; cable systems obtain power from interconnection points near utility poles where the cables are attached which is less reliable.¹⁰¹ In addition, the shared platform architecture of cable systems results in lower transmission speeds as more users utilize a link.¹⁰² Further, the shared platform architecture raises data security concerns and transmission performance issues that are of concern to business customers.¹⁰³ Basically, cable company service offerings are “an imperfect substitute for service provided over DS1 loops” because of bandwidth, security, and other technical limitations.”¹⁰⁴

¶ 193 (“The record indicates that cable providers are focusing their marketing strategies on residential users and ‘small and medium businesses ... that are near the residential network.’”).

⁹⁹ *TRRO*, ¶ 193.

¹⁰⁰ ETI White Paper at 23.

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ ETI White Paper at 27.

¹⁰⁴ *TRRO*, ¶¶ 193-194, n.512.

Due to the technical shortcomings of cable services, it is “unsuitable for most business applications, with the possible exception of telecommuting.”¹⁰⁵ Given these limitations, it is not surprising that cable companies provide connections to “less than one percent of potentially addressable business locations” and businesses, mostly small, represent no more than 5% of cable customers.¹⁰⁶ Accordingly, cable services cannot be considered a viable alternative to ILEC special access services, especially at this time.

Fixed wireless is also an inadequate replacement for wireline special access services. Fixed wireless services have been plagued by numerous technical and operational problems including “security and possible performance degradation from interference with other service providers.”¹⁰⁷ Accordingly, fixed wireless accounts for only about 25,000 enterprise lines nationwide which, assuming they were all special access lines, would amount to less than two hundredths of a percent of the special access market.¹⁰⁸

¹⁰⁵ *Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services*, CC Docket No. 01-337, Comments of the Ad Hoc Telecommunications Users Committee, at 17-18 (March 1, 2002).

¹⁰⁶ *Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services*, CC Docket No. 01-337, Reply Comments of the Ad Hoc Telecommunications Users Committee, at 4-6 (April 22, 2002).

¹⁰⁷ ETI White Paper at 23-24.

¹⁰⁸ *Id.*

4. The Proposed SBC/AT&T and Verizon/MCI Mergers Will Eliminate Competition For Special Access Services And Enable These BOCs to Further Inflate Their Special Access Rates and Implement a Price Squeeze Against Competitors in Other Markets

As stressed by many commenters in this proceeding,¹⁰⁹ the proposed mergers of AT&T with SBC and MCI with Verizon, if consummated, will virtually eliminate what little competition exists in the special access market and further enhance the BOCs' power to continue to inflate their special access prices and engage in exclusionary conduct in the special access market, while undermining competition in other markets through their monopoly control of critical special access inputs in their respective regions. The BOCs cannot credibly argue otherwise because they have characterized AT&T and MCI as both the largest competitive suppliers and the largest competitive purchasers of special access services in the nation.¹¹⁰

Indeed, the experience of competitive carriers such as Sprint and Broadwing in seeking alternatives to BOCs' facilities bolsters the conclusion that "AT&T and MCI are the largest competitive suppliers of special access services" by a very large measure.¹¹¹ As observed by the Professors Kahn and Taylor commenting on behalf of the BOCs, AT&T and MCI became the largest competitive providers of special access services, in part, by purchasing the three formerly largest competitive access providers: Teleport, which was acquired by AT&T in January, 1998;

¹⁰⁹ See, e.g., BT Americas Comments at 7-12; Broadwing Comments at 4, 19-22; Sprint Comments at 7-8; WilTel Comments at 12-13.

¹¹⁰ BT Americas Comments at 7; Declaration of Alfred E. Kahn and William E. Talyor on behalf of BellSouth, Qwest, SBC and Verizon, RM-10593, at 23-24 and Table 14, (Dec. 2, 2002).

¹¹¹ See, e.g., Broadwing Comments at 4, 19 ("The SBC-AT&T and Verizon-MCI mergers will therefore reduce the competitive provision of special access facilities in the SBC and Verizon regions from three potential suppliers to two.").

MFS, which was acquired by WorldCom in August, 1996; and Brooks Fiber, which was acquired by WorldCom in October, 1997.¹¹²

As a result of the proposed SBC-AT&T and Verizon-MCI mergers, competitive carriers, non-BOC CMRS providers, and businesses, will lose access to their largest actual, and potential competitive alternatives for their critical special access inputs because the AT&T and MCI networks will no longer be available as a source of competitive supply. In addition, the mergers will significantly remove the two largest non-BOC purchasers of special access, thereby dramatically reducing independent demand for special access services to such an extent that competitors will be deterred from investing in special access services due to the improbability of obtaining a sufficient customer base needed to recoup the huge sunk costs required to compete in the special access market.¹¹³

The mergers also threaten to undermine the wholesale market for special access. AT&T and MCI are nearly the only carriers that have sufficient demand to qualify for the highest volume discounts offered by the BOCs. In fact, AT&T and MCI buy “many more special access circuits per month *from each ILEC* than companies like SAVVIS,” Broadwing, and other carriers purchase across the country.¹¹⁴ As a result, AT&T and MCI qualify for large discounts from the BOCs’ inflated special access rates and presently resell some of these services to competitive carriers who serve business accounts. These discounted rates will no longer be available to the

¹¹² BT Americas Comments at 7.

¹¹³ BT Americas Comments at 10.

¹¹⁴ Broadwing Comments at 19.

vast majority of competitive carriers because after the merger AT&T and MCI are unlikely to continue to resell these BOC special access circuits to competitors.¹¹⁵

It is likely that AT&T and MCI, as the BOCs' largest customers for special access, exerted some disciplining effect on BOC special access prices by virtue of their large volume of purchases and the threat of extending their own fiber networks to reach some locations.¹¹⁶ This disciplining effect will be lost with the mergers. The mergers will also reduce the horizontal competition in the special access market from 3 potential competitors (namely, AT&T, MCI and Sprint) to only two in Verizon's and SBC's incumbent serving areas. As the Commission recognized, large fixed and sunk costs, economies of scale, the difficulty of securing rights of way, and operational impediments make it unlikely that other competitive carriers will be able to replace the services and facilities already offered by the largest existing competitive providers -- AT&T and MCI.¹¹⁷

If approved, the consolidation created by them will enable the BOCs to extort even higher prices and rates of return from their competitors for their critical special access inputs and engage in a price squeeze that will undermine competition in other markets.¹¹⁸ As the Commission observed, "business customers, commercial mobile radio service (CMRS) providers, interexchange carriers (IXCs), and competitive LECs all use special access services as

¹¹⁵ BT Americas Comments at 9; Broadwing Comments at 20.

¹¹⁶ Broadwing Comments at 19-21.

¹¹⁷ *TRRO*, ¶¶ 150-151; Broadwing Comments at 21.

¹¹⁸ BT Americas Comments at 10-11 ("price squeezes involving special access are especially likely with respect to enterprise customers because special access constitutes a significant percentage of the overall cost of the service."); Broadwing Comments at 19.

a key input in many of their respective service offerings.”¹¹⁹ In fact, for some carriers such as Broadwing, \$.50 to \$.60 of every dollar of revenue is spent to procure a BOCs’ special access services.¹²⁰

If the mergers are approved, the BOCs would have every incentive and the ability to exploit their increased dominance in the special access market in order to raise the costs of key inputs and engage in a price squeeze against competitors in other markets. As Broadwing noted:

At a fundamental level, the real cost of special access to a competitor that must rely on the ILEC is the cost the ILEC charges. The real cost of special access provisioned by the ILEC to itself [or its new affiliates], however, is the facility’s forward-looking economic cost. If the ILEC’s rates exceed those costs – and there is good reason to think they already do – competitors will be squeezed.¹²¹

Thus, by engaging in a price squeeze, Verizon and SBC will be able to provide their own long distance, wireless and other affiliates with a strategic cost advantage for key special access assets while still obtaining supra-competitive prices for their special access services from other carriers and customers.

Moreover, after the mergers, SBC and Verizon will have the incentive and ability to establish volume and term discount plans that only their largest customers for such services, such as SBC’s AT&T affiliate and Verizon’s MCI affiliate, can qualify for. Because of this, the BOCs will be able to engage in a price squeeze by offering these affiliates substantial volume discounts, while continuing to overcharge and discriminate against non-BOC carriers for the same services.

¹¹⁹ *NPRM*, ¶ 3.

¹²⁰ Broadwing Comments at 29.

¹²¹ *Id.* at 30.

5. The Commission Has Already Determined In The *TRO* And Confirmed In The *TRRO* Proceeding That There Are Few Competitive Alternatives To ILEC Special Access Services After Reviewing A Similar Voluminous Record Submitted By the ILECs

Although the record plainly refutes the BOCs' assertions that competition is widespread and thriving, the Commission recently laid to rest many of the BOC arguments being resurrected as to this precise issue. In particular, during the *TRRO* proceeding, the Commission reviewed much of the same voluminous evidence submitted by the ILECs in this proceeding¹²² and determined that there are so few competitive alternatives to ILEC loops and transport that a "reasonably efficient" competitor is "impaired" in competing with the ILECs absent access to unbundled ILEC DS1 and DS3 loops and transport in all but a small percentage of the most dense wire centers in the core business districts where significant numbers of fiber-based collocators are present.¹²³ Specifically, the Commission concluded that competing carriers were impaired absent unbundled DS1 transport, DS3 transport, and DS1 loops in all but 5.4%, 8.5%, and 0.5% respectively of BOC wire centers.¹²⁴

The Commission's conclusions in the *TRO* and *TRRO* are relevant to this proceeding because special access services use the same facilities as unbundled loops and transport.¹²⁵ In

¹²² Verizon, for example, acknowledges that the MSA data upon which it relies in this proceeding "were collected and analyzed during Verizon's preparation of responses in the 2004 *Triennial Review Remand* proceeding." Verizon Comments at 24, n.17.

¹²³ *TRRO*, ¶¶ 5, 24, 115, 118-119, n.337, 178-179.

¹²⁴ *TRRO*, ¶¶ 5, 24, 115, 118-119, n.337, 126; 129-130, 146, 166, 171-174, 178-179 ("competitive deployment of stand-alone DS1-capacity loops is rarely if ever economic"); *TRO*, ¶¶ 386-387, 391-392.

¹²⁵ As Sprint noted in the *TRO* proceeding, "Channel terminations are essentially the same as high-capacity loops, and thus the lack of alternatives for special access equates to a lack of alternatives for high capacity loops," and visa versa. *Review of the Section 251 Unbundling*

the *TRRO*, the Commission concluded that unbundling of loops and transport was generally “necessary” because insufficient competitive alternatives exist outside all but the largest wire centers for such facilities and self-deployment is infeasible given the potential revenue opportunities.¹²⁶ For example, the Commission found in the *TRO* and confirmed in the *TRRO* that “competing carriers generally cannot self-provide transport.”¹²⁷ Based upon its observed lack of competitive alternatives and the infeasibility of self-provisioning, the Commission required extensive unbundling of transport and loops along most routes.¹²⁸ By the same logic, there is dearth of competitive facilities for special access services (the equivalent facilities) in all but a small percentage of wire centers such that deregulation and pricing flexibility is infeasible because the potential for competition from competitive facilities is insufficient to constrain BOCs from engaging in monopolistic price increases.

With respect to competitive alternatives to ILEC loop facilities at commercial buildings, the Commission has already concluded that alternatives are rarely available because only “between 3% and 5% of the nation’s commercial office buildings are served by competitor-owned fiber loops,” and these alternatives were deployed “predominantly” only where traffic exists at the OC-n level.¹²⁹ The Commission recognized that “the record contains little evidence

Obligations of Incumbent Local Exchange Carriers, CC Docket No. 01-338, Comments of Sprint Corporation, at 24 (April 5, 2002).

¹²⁶ *TRRO*, ¶¶ 5, 24, 115, 118-119, n.337, 126; 129-130, 146, 166, 171-174, 178-179.

¹²⁷ *TRRO*, ¶ 126; *TRO*, at ¶ 391-392.

¹²⁸ *TRRO*, ¶¶ 115, 118-119, n.337, 126; 129-130, 146, 166, 171-174, 178-179.

¹²⁹ *TRO*, ¶ 298, n.856.

of self-deployment, or availability from alternatives for DS1 loops.”¹³⁰ The Commission observed that “[b]ased on the record as a whole, for DS1 loops and some DS3 loops, overbuilding to enterprise customers that require services over these facilities generally does not present sufficient revenue opportunity for competitors to recover their costs and, therefore, may not be economically feasible.”¹³¹ These conclusions are equally true for special access channel terminations which are functionally equivalent to UNE loop facilities.

With respect to transport, the Commission determined in the *TRO* and confirmed in the *TRRO* that “competing carriers generally cannot self-provide DS1 transport” and a “carrier requiring only DS1-capacity transport between two points typically does not have a large enough presence along a route (generally loop traffic at a central office) to justify the high fixed and sunk costs of self-provisioning just that DS1 circuit.”¹³² Further, the Commission found in the *TRRO* that “DS1 transport is not generally available on a wholesale basis.”¹³³ As a result, the Commission found that a reasonably efficient carrier would be impaired and required the BOCs to unbundle DS1 transport between any pair of wire centers except between a pair of Tier 1 wire centers.¹³⁴ Under this test, unbundling of DS1 transport was required to all but 5.4 percent of the BOC wire centers.¹³⁵ Similarly, based upon the dearth of competitive alternatives to BOC DS3

¹³⁰ *TRO*, ¶ 298.

¹³¹ *TRO*, ¶¶ 325, 298, n.859 (“scant evidence of wholesale alternatives for serving customers at the DS1 level”); *see, TRRO*, ¶¶ 146, 151-153 (“the barriers to entry impeding competitive deployment of loops are substantial”).

¹³² *TRRO*, ¶ 126; *TRO*, ¶ 391.

¹³³ *TRRO*, ¶ 126; *TRO*, ¶ 392.

¹³⁴ 47 C.F.R. § 51.319(a).

¹³⁵ *TRRO*, ¶ 115.

transport and the often prohibitive cost of self-deployment, the Commission required the BOCs to provide UNE DS3 transport unless both wire centers defining the route are either Tier 1 or Tier 2 wire centers.¹³⁶ Thus, carriers are impaired and BOCs are required to provide unbundled DS3 transport at all but 8.6% of BOC wire centers.¹³⁷

The Commission also recognized, as previously discussed, that there is little intermodal competition from fixed wireless and cable companies for loops and transport for enterprise customers. Specifically, the Commission concluded that “while there was some fixed wireless entry in the enterprise market, it has been limited.”¹³⁸ The Commission’s review demonstrated that “cable companies predominantly compete in the mass market for broadband services” while in the enterprise market “such competition is evolving more slowly and in more limited geographic areas.”¹³⁹ Thus, the Commission has already dismissed ILEC claims, raised again in this proceeding, that there is “rampant” competition from intermodal providers of loops and transport.

For all the above reasons, pricing flexibility and the CALLS plan have backfired and failed to produce competitive special access rates. The BOCs retain dominant control over the special access marketplace, and competitive market forces (to extent there are any) are unable to force BOCs to reduce their special access rates to competitive levels. Instead, the exact opposite

¹³⁶ 47 C.F.R. § 51.319(e); *TRRO*, ¶ 129.

¹³⁷ *TRRO*, ¶¶ 115, 118.

¹³⁸ *TRO*, ¶ 45, n.144.

¹³⁹ *TRRO*, ¶ 39, n.119 (“If business class able modem services really were comparable to DS1 level services, businesses would not be willing to pay 5 times as much for a DS1 as they do for a business cable modem connection.” *quoting*, ALTS Reply Comments at 33.).

is occurring - BOCs are capitalizing on their continued and ever expanding marketplace dominance by increasing rates.

II SPECIAL ACCESS RATES SHOULD BE RE-INITIALIZED AND PRICE CAP RULES SHOULD BE REFINED

A. Rates Should Be Re-Initialized

As demonstrated special access prices are far above forward-looking, cost-based levels and the lack of competition permits BOCs to obtain windfalls amounting to billions of dollars per year in overcharges.¹⁴⁰ Accordingly, the Joint CLECs reiterate their contention that the Commission should reinitialize special access prices at forward-looking cost-based levels and then subject them to modified price cap rules on a going forward basis.¹⁴¹

Verizon coyly notes that “there is no evidence that any carrier’s special access rates exceed the cap”¹⁴² and conveniently avoids mentioning any rates under pricing flexibility, which are the ones that the Commission is most concerned about. As Ad Hoc Users established, “it is evident that the Bells’ rate decreases from 2001 to 2004 have come almost solely from price cap rates”¹⁴³ and that “the amount of rate decreases that the Bells filed below the levels required by price cap regulation were negligible.”¹⁴⁴

¹⁴⁰ See *supra* Section I; Joint CLECs Comments at 3-13.

¹⁴¹ See Joint CLECs Comments at 13-24. This involves abolishing Phase II pricing flexibility and reinitializing all special access rates. See Section III, *infra*; Joint CLECs Comments at 32-35.

¹⁴² Verizon Comments at 40.

¹⁴³ Stith Declaration, ¶ 18.

¹⁴⁴ *Id.* ¶ 19.

Verizon argues that re-initialization will “undermine the credibility of the incentive-based system”¹⁴⁵ Because competitive carriers are being punished under this system by having to pay excessive special access rates, the credibility and effectiveness of such an incentive based system has been destroyed by the BOCs themselves. While “[p]rice cap regulation is intended . . . to reward efficient behavior and punish inefficient behavior,”¹⁴⁶ this intent unfortunately has not been realized. Instead, price cap regulation, combined with pricing flexibility, has rewarded monopolistic behavior and punished the consumer with unreasonable special access rates. There can be no doubt that pricing flexibility rates are higher than rates that would likely be available if the special access market were competitive. Although Verizon condemns any Commission action that might appropriate the “rewards” of its efficiency that occurred since price cap rules became effective,¹⁴⁷ it is unreasonable to expect that the Commission will remain blind to the difference between a reward on one hand and monopolistic exploitation of a faulty regulatory scheme on the other.

BOC assertions that re-initialization will be an arbitrary action on the Commission’s part fly in the face of the careful and studied manner in which the Commission has addressed special access rate regulation in the last fifteen years. As early as 2001 it became apparent that the Commission’s pricing flexibility rules were not having the intended effect, and AT&T’s Petition has simmered for almost three years. A course-correction made necessary by the wide divergence between expectations and results is by no means “arbitrary,” and is in fact the

¹⁴⁵ Verizon Comments at 41.

¹⁴⁶ *Id.* at 40.

¹⁴⁷ *Id.* at 41.

Commission's duty¹⁴⁸ and there are economic benefits in doing so.¹⁴⁹ Moreover, any reasonable business should realize that, far from being arbitrary, such an action is inevitable, forced as it is by the BOCs continued abuse of their pricing flexibility.

SBC states the obvious, as if it some kind of profound insight, when it complains that re-initialization of rates will "provide a wealth transfer from those BOCs to purchasers of special access."¹⁵⁰ *Of course it will* – that is, after all, the underlying principle of all rate regulation, and the Commission should not shy away from this. Characterizing rate re-initialization as a "Redistribution of wealth" is entirely inappropriate. It is more intellectually honest to state that re-initialization will *return* wealth to ratepayers since BOCs are currently reaping excessive profits by assessing charges that far exceed forward-looking, economic costs. Over a century ago, Congress determined that the concentration of wealth in one monopoly supplier is harmful to the public interest, and that the economy as a whole is sounder when all participants have the

¹⁴⁸ See *Bechtel v. FCC*, 957 F.2d 873, 881 (D.C. Cir. 1992) ("The Commission's necessarily wide latitude to make policy based upon predictive judgments deriving its general expertise implies a correlative duty to evaluate its policies over time to ascertain whether they work – that is, whether they actually produce the benefits the Commission originally predicted they would."); *ACLU v. FCC*, 823 F.2d 1554, 1565 (D.C. Cir. 1987) (the D.C. Circuit has specifically "emphasize[d] the need for the Commission to vigilantly monitor the consequences of its rate regulation rules" where, as here, "the Commission itself has recognized the tentative nature of its predictive judgments.").

¹⁴⁹ See Letter from Brian R. Moir, Partner, Moir & Hardman, to Marlene H. Dortch, Secretary, FCC, RM-10593 (June 12, 2003) (attaching macroeconomic analysis of the impact on the U.S. economy if excessive special access prices were lowered to reasonable levels. This study demonstrated that by reducing special access rates to levels that would produce an 11.25% return would result in immediate positive benefits by adding \$14.5 billion to the U.S. economic output (Gross Domestic Product) and by creating 132,000 new jobs in the first two years.).

¹⁵⁰ SBC Comments at 38.

opportunity to achieve a competitive rate of return. Re-initialization of rates is necessary to ensure that this happens going forward.

In the same vein, there is nothing profound in SBC's pronouncement that a reinitialized price-cap regime is "just rate-of-return regulation by another name."¹⁵¹ Whatever one chooses to call it, the BOCs' rates-of-return for services in which they continue to have a monopoly position must be regulated, and the Commission has a duty to do so, because the BOCs' continued dominance of the special access market renders the market unable to constrain the BOCs' special access prices.

The Commission should also not be overly concerned by threats¹⁵² that that it will quash BOC incentives to become more efficient – unless it believes that BOCs can only be motivated by the opportunity to garner unreasonably high returns. In economic terms, it should be incentive enough for any business to achieve rates of return that are obtainable when the marketplace is competitive. To expect more than that is truly a manifestation of a monopoly mindset – and proof that the BOCs face no competition in the special access market.

In their initial Comments, Joint CLECs recommended that the Commission reinitialize special access rates and set them at forward-looking economic cost-based levels that are reflective of a competitive marketplace, especially since the Commission has already concluded that "access charges should ultimately reflect rates that would exist in a competitive market."¹⁵³

¹⁵¹ *Id.* at 38.

¹⁵² Qwest Comments at 17; SBC Comments at 38.

¹⁵³ See Access Charge Reform Order, ¶ 72.

Joint CLECs disagree with Qwest that “the use of cost studies is problematic.”¹⁵⁴ While it is true that they are “expensive, time consuming and administratively burdensome,”¹⁵⁵ this effort has already been undertaken throughout the nation in TELRIC UNE cost proceedings. If special access were truly competitive, rates would reflect forward-looking economic costs, including a reasonable allocation of forward-looking joint and common costs, and allow incumbent LECs to earn a fair, risk-adjusted rate-of-return on their investments.¹⁵⁶ Thus, re-initialization using UNE rates does not entail undue administrative burdens. If the BOCs, however, believe that such rates do not cover their costs, the Commission could invite them to file forward-looking cost studies instead. The Commission previously permitted the BOCs to do this (which the BOCs chose not to do) instead of opting for other alternatives that were available to them.¹⁵⁷

B. The X-Factor Should Be Re-Applied

In their initial Comments, Joint CLECs recommended that once special access rates are reinitialized, the Commission should include all special access rates under a modified price cap regulatory framework¹⁵⁸ and make a productivity-based X-factor a key feature of such new rules. Because BOCs threaten to reduce their investment in network efficiencies in the face of new price caps, it is even more important that the Commission reinstitute an X-factor to ensure that

¹⁵⁴ Qwest Comments at 16 – 17.

¹⁵⁵ *Id.* at 17.

¹⁵⁶ *Access Charge Reform*, CC Docket Nos. 96-262, 94-1, 91-213, 96-263, Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, 11 FCC Rcd 21354 ¶ 222; *Local Competition Order*, ¶ 672.

¹⁵⁷ *CALLS Order*, ¶¶ 29, 56-62; *NPRM*, ¶ 14.

¹⁵⁸ This involves bringing all special access services in existing Phase II MSAs back within price caps.

BOCs capitalize on the technological advancements of their suppliers to improve their special access productivity.

Verizon and Qwest argue against a special access specific X-factor because “[s]pecial access services are not produced on a stand-alone basis; they use the same network facilities and managerial functions as all of the other outputs of a telecommunications firm.”¹⁵⁹ However, this actually militates in favor of a specific X-factor, since, as the Ad Hoc Users noted,¹⁶⁰ it follows that extraordinarily high special access returns must be covering the costs of other services – probably permitting the BOCs to subsidize competitive or quasi-competitive services through rates on non-competitive special access services. Rather than using their excess earnings to undermine their competition in the limited circumstances where they face it, the BOCs should be sharing these benefits with carrier consumers. One tool for doing just that is the X-factor. Even if it is based on overall BOC productivity, including the factor in the price cap formula is still appropriate for the same reasons it was in the past.¹⁶¹

SBC argues that the proposed 5.3% X-factor is unsuitable because it was developed 10 years ago and covered all price cap services, not just special access. If anything, this suggests that 5.3% may be too low, since recent BOC technology enhancements appear to be focused in last mile facilities (e.g. hybrid loops, FTTC, FTTH), which would have a greater proportional effect on special access service efficiency than it would for other price cap services like switched access or transport.

¹⁵⁹ Verizon Comments at 42; *see also* Qwest Comments at 9.

¹⁶⁰ ETI White Paper at 33.

¹⁶¹ *See LEC Price Cap Order*, 74-119.

Verizon and SBC disingenuously claim that there is no basis for believing that BOCs enjoy productivity levels significantly greater than the economy as a whole.¹⁶² Clearly, neither of these commenters made the slightest attempt to verify this assertion. Actually, the data are readily available from the Bureau of Labor Statistics, and demonstrate that for the period from 1996 through 2002, overall U.S. productivity growth averaged 2.9% per year,¹⁶³ while the wired telecommunications sector exceeded that by a considerable margin – growing an average of 5.4%.¹⁶⁴ This amount is strikingly close to the proposed X-factor of 5.3%, undermining SBC’s claim that “this 5.3% figure is [not] at all relevant to any increased productivity experienced by *today’s* carriers”¹⁶⁵ Because LEC productivity continues to outpace that of the economy as a whole, the Commission should reject suggestions like Verizon’s and Qwest’s that the X-factor remain pegged to inflation¹⁶⁶ or be reduced to zero.¹⁶⁷ In every sense, these are appeals for the *status quo* that, as the Joint CLECs and other commenters have established, would mean that

¹⁶² Verizon Comments at 43, n.30; SBC Comments at 40-42.

¹⁶³ United States Department of Labor, Appendix Table 1. Business sector: Revised productivity, hourly compensation, and unit labor costs, and prices, seasonally adjusted, *available at* <http://www.bls.gov/news.release/prod2.t07.htm>. To arrive at this figure, the average percentage of the reported year-to-year index growth was calculated over the years 1996 through 2002.

¹⁶⁴ United States Department of Labor, Industry Productivity Costs, Wired Telecommunications Carriers, *available at* <http://data.bls.gov/cgi-bin/surveymost?ip>. To arrive at this figure, the average percentage of the reported year-to-year index growth was calculated over the years 1996 through 2002.

¹⁶⁵ SBC Comments at 46 (emphasis in original).

¹⁶⁶ Verizon Comments at 41-43.

¹⁶⁷ Qwest Comments at 10.

BOC customers would see none of the benefits of productivity gains, which would continue to accrue to the BOCs as monopoly rents.¹⁶⁸

SBC further contends that “developing an economically correct and relevant productivity factor is a practically insurmountable challenge,”¹⁶⁹ and cites to the D.C. Circuit’s 1999 rejection of the Commission’s 1997 revisions to the X-factor formula.¹⁷⁰ SBC fails to mention that an X-factor had been in effect for seven years prior to that, apparently without bringing the industry to its knees. Moreover, as the Commission well knows, the D.C. Circuit did not condemn the concept of an X-factor, nor the formula by which it was calculated. Instead, it criticized the Commission’s lack of explanation for the process by which it selected the data to enter into the formula. Specifically, the court determined that the Commission should have explained (1) why outlying historical productivity data was unreliable or its use inappropriate,¹⁷¹ (2) how it determined that there was an upward trend in the historical data,¹⁷² and (3) why it accepted estimates of the range of reasonableness based on methodologies that it had previously discredited.¹⁷³ This by no means amounts to an indictment of the X-factor concept, nor do any of these criticisms portray an “insurmountable” problem. The Commission established legally sustainable X-factors in the past and can establish them in the future. Although the BOCs balk at

¹⁶⁸ See, e.g. Joint CLECs Comments at 24-26; T-Mobile Comments at 21-22; Nextel Comments at 18-20; Sprint Comments 12-13.

¹⁶⁹ SBC Comments at 43.

¹⁷⁰ SBC Comments at 44 (citing *United States Telecom Ass’n v. FCC*, 188 F.3d 521 (D.C. Cir. 1999)).

¹⁷¹ *United States Telecom Ass’n v. FCC*, 188 F.3d at 525.

¹⁷² *Id.* at 526.

¹⁷³ *Id.*

this notion altogether, the BOCs have provided their expense matrix data from 1994 to 2004 (as requested in paragraph 36 of the *NPRM*) that is needed for the Commission to establish a sound and updated X-factor.

SBC goes on to erroneously portray the Commission as “*explicitly* rejecting the suggestion that it establish a productivity factor specific to special access services” because it would rely on ARMIS data.¹⁷⁴ This is wholly untrue. The paragraph SBC cites does not mention special access at all, let alone “explicitly” reject a special access productivity factor, and nowhere in that FCC notice is ARMIS even mentioned. This paragraph merely speculates on the theoretical and practical issues of calculating total factor productivity (specifically) on a less-than-total-company basis.¹⁷⁵

To address these shortcomings and consistent with its justification in the *LEC Price Cap Order*, the Commission should re-impose a productivity-based X-factor in the price cap formula to ensure that rates continue to decline relative to the measure of inflation, GNP-PI.¹⁷⁶ Although the Commission should, at a minimum, apply the X-factor prospectively, it should also apply it

¹⁷⁴ SBC Comments at 44 (citing *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, Fourth Further Notice of Proposed Rulemaking, 10 FCC Rcd 13659, ¶ 69 (1995)(emphasis supplied)).

¹⁷⁵ For the record, the paragraph is as follows: “As we discussed above, calculating TFP on a less-than-total-company basis may present both theoretical and practical issues. Our resolution of these issues may be related to our conclusions regarding the interstate TFP issue designated above. If we find that it is not possible to distinguish the productivity associated with interstate services from that associated with intrastate services, then it may not be possible to distinguish between the productivity associated with regulated services from that associated with non-regulated services, or to distinguish the productivity associated with any other service or group of services.” *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, Fourth Further Notice of Proposed Rulemaking, 10 FCC Rcd 13659, ¶ 69 (1995).

¹⁷⁶ *LEC Price Cap Order*, ¶ 75

retroactively back to 2004,¹⁷⁷ when the Commission, under the CALLS Plan, effectively eliminated the X-factor and froze the Price Cap Index (“PCI”).

C. Sharing Should Be Re-Imposed

The Commission erred in 1997 when it eliminated the sharing requirement, because it put the cart before the horse. In its discussion, the Commission implied that the pace of *expected* competitive entry would obviate the need for sharing, or might even be somehow advanced by eliminating the sharing requirement:

We also conclude that our new price cap structure better suits the *advent* of competition that lies at the heart of the 1996 Act. Subjecting incumbent LECs to a price cap structure that better replicates the discipline of a competitive marketplace is warranted *as we move toward* competition itself. Furthermore, we conclude that we should adopt a price cap structure that readily lends itself to the further regulatory changes we *anticipate* will be warranted *as competition develops* for access services in various geographic areas.¹⁷⁸

Joint CLECs join many others in wishing that circumstances had justified the Commission’s confidence in the inexorable pace of competition that it anticipated in 1997. Unfortunately, this did not turn out to be the case.

Joint CLECs concur with Ad Hoc Users that sharing is important as a correction for a miscalculated X-factor, and that a “zone” structure like before is appropriate. If the prospect of “only” achieving steady returns that average or exceed 12 percent (in a primarily non-

¹⁷⁷ Since substantial evidence demonstrates that special access rates are unreasonable, such retroactive true-ups would be permissible. *Arizona Grocery Co. v. Atchison, Topeka & Santa Fe Railway Co.*, 284 U.S. 370, 384, 387-89 (1932) (A carrier charging a merely legal rate (in that it was properly filed) may be subject to refund liability if customers can later show that the rate was unreasonable. Should an agency declare a rate to be lawful, however, refunds are thereafter impermissible as a form of retroactive ratemaking).

¹⁷⁸ *1997 Price Cap Review Order*, ¶ 150 (emphasis supplied).

competitive market, with a captive user base) is unattractive to the BOCs and a disincentive to further investment, most investors would be delighted to know of the alternate investments that the BOCs perceive to be more attractive in comparison, so they can divert their funds to those investments as well.

The BOCs cannot reasonably argue that they are being deprived of justly earned returns in the sharing zone, because if the market were as competitive as they claim it to be, *they would never have seen this level of return in the first place*. Moreover, whatever incentive the BOCs derive from supra-competitive returns are of no use to carrier consumers if all of the financial benefits of those incentives accrue as windfalls to the BOCs. As the Commission stated in the *LEC Price Cap Order*, “this level of sharing will ensure that consumers receive their fair share of productivity gains that occur, just as they would in an industry with keener competition.”¹⁷⁹

The overriding question is “How much is enough?” In reviewing the BOCs’ proposals, Joint CLECs are concerned that the BOC proposals are consistently comprised of absolutes that admit to no limiting concept. For example, while it may be true, as Verizon states, that “[t]he ability to earn short run supracompetitive prices . . . is the primary incentive to risk capital and effort in any kind of new venture,”¹⁸⁰ this statement is not reflective of the realities of the special access market. First of all, technology enhancements to current special access services are not speculative and risky “new ventures”(e.g. in the sense of building a new jumbo jet) that deserve supracompetitive returns to compensate for this risk. They are merely more efficient ways of offering a service for which the BOCs already have a dominant, installed base of captive

¹⁷⁹ *LEC Price Cap Order*, ¶ 124.

¹⁸⁰ Verizon Comments, Taylor Declaration, ¶ 86.

customers. Second, absent the development of competition (which has historically been slow to develop), there is no “short run” in a price cap regime. Without some type of limiting rules, price cap LECs will continue to earn windfall profits indefinitely, perhaps mitigated only by any applicable X-factor.¹⁸¹

D. Baskets and Categories Proposed by Joint CLECs Should Be Adopted

SBC proposes that the Commission restructure the special access basket to contain just two service categories: “DS3 and below Channel Terminations to End Users” and “All Other”, arguing dividing the remaining services into two baskets correctly groups the price cap services that face the most similar competitive conditions.¹⁸² SBC’s proposal also eliminates separate categories for Voice Grade, WATS, Metallic services, and Audio & Video service and tosses them into its proposed “All Other” service category and removes OCn services from price-cap baskets altogether.¹⁸³ It contends that “marketplace realities” warrant such changes to the service

¹⁸¹ The Joint CLECs do not propose any sharing thresholds but believe the thresholds the Commission previously adopted in the *LEC Price Cap Order* are appropriate if the outdated 11.25 percent rate of return is utilized. Specifically, in the *LEC Price Cap Order*, the Commission established three earnings sharing zones based on specific rates of return. *LEC Price Cap Order*, ¶¶ 122-26. In the first zone, price cap LECs were allowed to retain all of their earnings up to the first rate of return ceiling, 12.25 or 13.25 percent, depending on whether the LEC elected a 3.3 or 4.3 percent productivity factor. *LEC Price Cap Order*, ¶¶ 123, 126. In the second zone, price cap LECs were allowed to retain 50 percent and return to ratepayers 50 percent of their earnings between the first ceiling and the second ceiling, 16.25 or 17.25 percent, again depending on whether the LEC elected a 3.3 or 4.3 percent productivity factor. *LEC Price Cap Order*, ¶¶ 124, 126. In the third zone, price cap LECs were required to return 100 percent of any earnings above the second ceiling. *LEC Price Cap Order*, ¶¶ 125-26. If the Commission concludes that the rate of return should be lowered (as it should), the above sharing thresholds should be lowered commensurately. The productivity factors should be increased since the productivity of the wired telecommunications sector is 5.4%, which is far exceeds the overall U.S. productivity growth of 2.9%. *See supra*, nn.163 &164.

¹⁸² SBC Comments at 62.

¹⁸³ *Id.* at 63.

categories. Verizon goes one step further and recommends that the Commission eliminate all service categories and sub-categories within the special access basket.¹⁸⁴

The Commission should reject both of these proposals. Instead and for the reasons provided in the Joint CLECs' initial comments, it should modify its current scheme and adopt the Joint CLECs' proposal that establishes separate baskets for DS1 and DS 3 special access services and creates four categories within these baskets: (1) special access channel terminations between the LEC end office and the customer premises (*i.e.*, loops); (2) channel mileage between LEC central offices (*i.e.*, transport); (3) special access channel terminations between the IXC POP and the LEC serving wire center (entrance facilities) and (4) any other special access product related to the basket.¹⁸⁵ High capacity services above the DS-3 level (*e.g.*, OCn) should be placed in a separate basket that does not include categories insofar as the Commission's determination is correct that the market for these services is competitive.¹⁸⁶ Also, other retail services should have their own basket as well.

Moreover, Joint CLECs continue to believe that the Commission should also establish a separate basket for mass market broadband and DSL services. As Joint CLECs established in their initial Comments, these services compete directly with mass market cable (and to a small extent, wireless broadband) offerings, existing in a duopoly that, for the moment at least, is

¹⁸⁴ Verizon Comments at 37.

¹⁸⁵ The 5 percent upper pricing band that currently applies to special access services and categories should also apply to the baskets and categories being proposed herein "to protect ratepayers from substantial changes in services rates." *See LEC Price Cap Order*, ¶¶ 223-24; 47 C.F.R. § 61.47(e).

¹⁸⁶ *See, e.g., TRO*, ¶¶ 315 & 389.

fiercely price competitive, unlike traditional special access services.¹⁸⁷ If BOCs want to compete for these mass market customers, they should not be permitted to subsidize these services with their supracompetitive profits on non-competitive special access services. To prevent any threat of such anticompetitive conduct and cross subsidization, the costs and revenues associated with mass market broadband and DSL services should be assigned to a separate basket.

If the Commission is interested in fostering competition for telecommunications services, one of its most important tasks is to ensure against cost shifting from competitive services to non-competitive services. As stated previously, extraordinarily high special access returns must be covering the costs of other services – probably permitting the BOCs to subsidize competitive or quasi-competitive services through rates on non-competitive special access services. In the interests of protecting carrier consumers and competition, then, it is important that appropriate amount of segregation be afforded.

This is why it is necessary to segment the special access market. As the Commission explained in the *LEC Price Cap Order*, “[s]ubdividing LEC services into baskets substantially curbs a carrier's pricing flexibility, as well as its ability to engage in unlawful cost shifting between the broad groups of services. Whenever a set of rates is subject to a price ceiling, carriers have no incentive to shift costs into the basket because the cap does not move in response to endogenous cost changes.”¹⁸⁸

The Joint CLECs’ proposal appropriately segments the most relevant and recognized special access product markets to preclude cost shifting between such broad groups of services.

¹⁸⁷ *NPRM*, ¶ 52.

¹⁸⁸ *LEC Price Cap Order*, ¶ 200.

In addition, the categories proposed for the DS1 and DS3 baskets, which would be subject to rate ceilings, would minimize the BOCs ability to offset rate reductions where there is competition with rate hikes between and among the various categories where there is none. In contrast, Verizon's proposal fails to recognize any distinction across currently relevant special access services and SBC's proposal, with the exception of its proposed DS3 and below channel termination category, does as well.¹⁸⁹ Their proposals would not minimize the potential of cross-subsidization but rather would invite such actions. BOCs are already seizing every opportunity to shift costs to less competitive services from more competitive services¹⁹⁰ and the "marketplace realities" are that they would do this far more so if either of their proposals were adopted.

In support of its proposal that eliminates special access categories altogether, Verizon posits an example that has no relation to reality. One of Verizon's experts describes a situation in which supply or demand conditions result in fluctuations in the relative market prices for DS1 and DS3 services (short term due to the "fungibility" of bandwidth) to which LECs would not be able to rapidly adjust if the services were in different sub-baskets.¹⁹¹ The concept underlying this scenario is simply baffling. First, the idea that there is a "market" that sets the price for DS1 and DS3 services is implausible. An economist should know that "market" implies a collection of willing sellers and willing buyers with relatively comparable bargaining power and open communication, in which perfect (or near-perfect) competition exists so as to establish a "market" price for a good. As many commenters have established in this proceeding, this does

¹⁸⁹ Verizon Comments at 37; SBC Comments at 62.

¹⁹⁰ See, e.g., *NPRM*, n.153.

¹⁹¹ Verizon Comments, Taylor Declaration at 34.

not come close to describing the situation involving DS1 and DS3 circuits, particularly channel terminations to end-users. Second, the use of the term of “fungible” is completely inappropriate. There is no fungibility of bandwidth to a specific customer site. As other commenters have shown, for 95% of all end user sites, there is only one supplier of high capacity links - the BOCs.¹⁹² End users cannot source this “fungible” bandwidth like one would oil on the London spot market.

Verizon further states that baskets “inhibit [price cap LECs’] ability to compete by offering packages of services in whatever combinations customers want,”¹⁹³ but this is blatantly misleading and inherently nonsensical. Nothing in the current or proposed price cap rules prohibits LECs from offering services from different baskets in any combination. The only restriction is that elements from different baskets be priced in accordance with the current API for that particular basket.

Verizon also argues that “the rate structure that the Commission’s rules impose on special access services has no claim to efficiency.”¹⁹⁴ Admittedly, no regulatory scheme is going to be perfectly efficient, but neither is a deregulatory scheme, particularly in the presence of a dominant supplier who has every incentive to exploit its ratepayers to the extent it can. However, as Ad Hoc Users noted,¹⁹⁵ the price cap regime has been largely successful,

¹⁹² “RBOCs remain the sole source of dedicated access connectivity at roughly 98% of all business premises nationwide, even for the largest corporate users.” Gately Declaration at 13; *see supra* at 20-24 (citing ETI White Paper at iv, 12, 16).

¹⁹³ Verizon Comments at 37 (quoting Taylor Declaration ¶ 73).

¹⁹⁴ Verizon Comments, Taylor Declaration at 34.

¹⁹⁵ Ad Hoc Users Comments at 5.

particularly when contrasted with the pricing flexibility scheme, which backfired and triggered the exact opposite than what was anticipated. The Commission should take comfort from the words of one expert on whom Verizon relies, who has written that

[a]ll competition is imperfect; the preferred remedy is to try to diminish the imperfections. Even when highly imperfect, it can often be a valuable supplement to regulation. But to the extent that it is intolerably imperfect, the only acceptable alternative is regulation. And for the inescapable imperfections of regulation, the only available remedy is to make it work better.¹⁹⁶

Through regulation the Joint CLECs' proposal will protect and hopefully foster competition whereas the BOCs' proposal will do no such thing. For the reasons discussed, the Commission should establish baskets and categories as the Joint CLECs propose.¹⁹⁷

III THE COMMISSION SHOULD ABOLISH OR TIGHTEN PHASE II PRICING FLEXIBILITY

A. Requests For Further Phase II Relief Should Be Rejected

BellSouth requests that the Commission grant immediate Phase II pricing flexibility everywhere and discontinue all price regulation for special access after two years based on its

¹⁹⁶ Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions Volume II* 329 (1988).

¹⁹⁷ To the extent the Commission is disinclined to establish the additional baskets that the Joint CLECs propose (ostensibly out of concerns that the BOCs would not be able to achieve the total company productivity offset for each basket), the Commission should, at a minimum, establish separate "categories" for each of the baskets that Joint CLECs propose and "subcategories" for each of the categories that Joint CLECs propose. The 5 percent upper pricing band that currently applies to special access service categories and subcategories should apply to these new categories and subcategories so that ratepayers are protected "from substantial changes in service rates." *LEC Price Cap Order*, ¶¶ 223-24; 47 C.F.R. § 61.47(e). The Commission took such an approach in *LEC Price Cap Order. Id.*, ¶ 210.

more general arguments to the effect that there is extensive competition for special access service, and that its prices have not substantially increased.¹⁹⁸

However, BellSouth admits that some of its prices have increased about 2% per year.¹⁹⁹ Further, its argument that there have not been substantial and sustained price increases verifies, rather than disproves, that the market for special access is not competitive because in a competitive market prices would not be increasing but rather would be decreasing, a claim BellSouth does not make.

As the Commission recognized when it adopted what now is properly characterized as a ill conceived regulatory scheme, pricing flexibility if granted prematurely would “enable price cap LECs (1) to exclude new entrants from their markets, or (2) increase rates to unreasonable levels.”²⁰⁰ Unfortunately and as demonstrated above, this is exactly what occurred and the Commission’s theories that “irreversible, or ‘sunk,’ investment in facilities used to provide competitive services” would prevent this from happening were utterly wrong.²⁰¹

For all the reasons stated in these Reply Comments, the Commission should not provide further regulatory relief to BOCs. Substantial evidence in the record strongly suggests that BOCs enjoy unconscionable earnings, and are raising prices. BOCs’ submission of evasive revenue analyses and, indeed nearly everything other than a straightforward price comparison or rate-of-return study, is insufficient to rebut the substantial record evidence of excessive earnings

¹⁹⁸ BellSouth Comments at 48.

¹⁹⁹ BellSouth Comments at 16.

²⁰⁰ *Pricing Flexibility Order*, ¶ 68.

²⁰¹ *Pricing Flexibility Order*, ¶ 79.

and rising prices. Further regulatory relief would only lead to further pricing abuses by incumbents. If the Commission does not abolish Phase II pricing flexibility, it should at a minimum significantly tighten Phase II pricing flexibility as recommended below.

B. If Not Abolished, Phase II Pricing Flexibility Should Apply At The Wire Center Level For Interoffice Mileage

As the Commission recognized in the 1999 *Pricing Flexibility Order*, competition does not occur uniformly in an MSA, *i.e.*, there may be no competitive alternatives for special access service from some wire centers in an MSA otherwise eligible for Phase II pricing flexibility. More recently, as detailed in comments in the *Triennial Review Remand* proceeding, competitive transport alternatives occur in the marketplace on a route-by-route basis, not MSA wide. Accordingly, a route-by-route approach for Phase II pricing relief for interoffice transport would better reflect where competitive alternatives are actually available than does the current MSA-wide approach to Phase II relief.

Moreover, it is clear at this point that the triggers adopted in the 1999 *Pricing Flexibility Order* do not accurately measure where competition in an MSA is sufficient to constrain the BOCs' pricing and produce forward-looking pricing. As discussed in Joint CLECs' initial comments, prices have not been reduced and have generally increased where Phase II pricing flexibility has been granted.²⁰² This situation, by itself, completely invalidates the current triggers and MSA-wide approach for identifying where competition is sufficiently developed to supplant price cap regulation.

²⁰² Joint CLECs Comments at 10-13.

Moreover, the Commission has already developed triggers that identify where competitive transport alternatives may exist on a route-by-route basis. In the *Triennial Review Remand Order*, the Commission adopted a wire center approach for measuring impairment for access to interoffice transport as an unbundled network element.²⁰³ Under that approach, impairment for interoffice transport is determined by reference to the number of access lines or fiber-based collocators in the wire centers on both ends of the route. This approach inaccurately identifies routes where there are competitive alternatives because neither wire center density or fiber-based collocation determines the viability of competitive interoffice alternatives over a route. In addition, because the Commission's fiber-based collocator test did not treat AT&T and MCI as affiliates of SBC and Verizon, respectively, and because AT&T and MCI have fiber-based collocations in many BOC wire centers, the *TRRO*'s wire center fiber-based collocator test will have overstated the number of alternative competitive providers that actually exist in a wire center if the SBC/AT&T and Verizon/MCI mergers are approved.²⁰⁴ Despite these concerns, granting Phase II pricing flexibility based on route-by-route approach would be more accurate than the current MSA approach because transport competition would be identified on a basis closer to how it actually occurs in the marketplace, *i.e.* on a route-by-route basis.

Accordingly, the Commission should establish a wire center approach for determining eligibility for pricing flexibility for interoffice transport. In this vein, the Commission should not simply borrow the UNE triggers and use them for special access pricing flexibility. In the *Triennial Review Remand* proceeding, the Commission adopted rules seeking to address the

²⁰³ *TRRO*, ¶ 111.

²⁰⁴ Certain CLECs have requested reconsideration of this aspect of the *TRRO*. See CC Docket No. 01-338, Petition for Reconsideration of CTC *et al.* (dated Mar. 28, 2005)

direction of *USTA II* that the Commission's impairment standard must consider the potential for competitive deployment, not just actual deployment by competitors.²⁰⁵ The Commission is under no such direction in this proceeding from any court. Nor could a court provide any such direction, because the Commission in this proceeding is implementing the broad obligations of Sections 201(b) and 202(a) of the Act that carriers charge just, reasonable, and non-discriminatory prices, rather than the more specific statutory impairment standard on which the *USTA II* guidance was based.

Moreover, triggers based on potential deployment are subject to abuse by the BOCs. As demonstrated in the record of this proceeding, BOCs will raise prices where competitive alternatives are not available if triggers inaccurately grant pricing relief where there is no competition. Therefore, in this proceeding the Commission need not consider potential deployment, and should use wire center thresholds for Phase II relief that are better tailored to identify where competition may actually exist.

More specifically, the Commission should adopt a route-by-route approach for Phase II relief that employs substantially higher thresholds than those adopted in the *Triennial Review Remand Order*.

²⁰⁵ *TRRO*, ¶ 93.

C. If It Is Retained In Any Respect, Phase II Pricing Flexibility Should Apply To Channel Terminations On A Building-Specific Basis

For the same reasons that an MSA approach to Phase II pricing flexibility is inappropriate for transport, it is also not suitable for Phase II pricing flexibility for channel terminations. Competition for loops does not occur uniformly throughout an MSA; the specific triggers adopted by the Commission in the 1999 *Pricing Flexibility Order* do not accurately identify where competitive alternatives to loops are available; and experience under Phase II pricing flexibility has shown that it has not produced competitive prices but instead has backfired and permitted BOCs to increase prices for special access channel terminations.

However, unlike transport, a wire center approach is not suitable for Phase II pricing flexibility because competitive alternatives for loops occur on a building-specific basis. It is an obvious point that the existence of competitive alternatives to serve one building does not mean that competitive alternatives are, or could be, available to other buildings in an MSA or served by the same wire center for any number of reasons, including different revenue opportunities presented by the type of customer in each building, and different loop construction costs. For the same reasons, the existence of fiber-based collocators in a wire center does not elucidate if either those or other collocators do or could offer competitive loop alternatives from that wire center.

In the *Triennial Review Remand Order*, the Commission recognized that a building-specific test would more accurately identify impairment than would a wire center approach.²⁰⁶ However, the Commission opted for a wire center approach for two reasons, *i.e.* because *USTA II* required the Commission to consider the potential for competition, not just actual competition,

²⁰⁶ *TRRO*, ¶ 155 (“a properly designed building-specific test could assess variations in impairment far more subtly than could a wire center or MSA-based approach ...”).

and because a building-specific approach would impose undue administrative burdens on the Commission.

As discussed above, the Commission is under no direction from any Court to consider potential competition in fashioning a revised test for Phase II pricing flexibility. And, because of the harm caused to special access customers and ultimately end user consumers by a test that inaccurately identifies competition, the Commission should confine any Phase II pricing flexibility test to measuring actual competitive alternatives that could constrain BOC prices rather than considering the theoretical possibility of competition. This is all the more reasonable for loops (*i.e.*, channel terminations) given that competitive provision of loops is rare.

Nor would a building-specific approach for channel termination Phase II pricing flexibility create undue administrative burdens. For example, the Commission could require the ILECs to certify, with supporting evidence, that four competitive providers serve a building. Competitive providers would then have an opportunity to challenge the certification and Phase II pricing flexibility would be granted unless the Commission issues an order denying the ILEC request. If it later transpires that the ILEC incorrectly certified a building, special access customers would be entitled to a refund to the extent they paid more than the price that would have been charged if Phase II pricing flexibility had not been granted. This is no more burdensome than the approach the Commission adopted in the *Triennial Review Remand Order* concerning notification by ILECs of copper loop retirements²⁰⁷ and less burdensome than the current approach for ILECs to obtain pricing flexibility in which the Commission issues orders

²⁰⁷ *TRO*, ¶ 282.

granting pricing flexibility. Accordingly, the Commission should establish a building-specific approach to Phase II pricing flexibility for channel terminations.

D. Pricing Flexibility Triggers Should Not Be Modified To Measure CLECs Networks Or Intermodal Competition

The Commission should reject the SBC and Verizon requests to modify triggers for pricing flexibility to take into account CLEC networks that do not rely on collocation in ILEC wire centers and intermodal competition.²⁰⁸ These carriers have been arguing in the *Triennial Review Remand Proceeding* that business line density and fiber-based collocation are satisfactory proxies for revenue opportunities that will adequately predict the actuality and potential for competition.²⁰⁹ They go so far as to contend that business line density and fiber-based collocation are sufficiently acceptable proxies for competition that it doesn't even matter what methodology the Commission uses in counting business lines as long as it is consistently developed and applied.²¹⁰ This advocacy negates BOC contentions in this proceeding that the fiber-based collocation triggers at issue in the instant proceeding are inadequate to predict competition.

Accordingly, the Commission should reject requests to modify pricing flexibility triggers in ways requested by BOCs.

²⁰⁸ Verizon Comments at 35; SBC Comments, Casto Declaration at 17.

²⁰⁹ Verizon Opposition to Petition for Reconsideration, WC 04-313, at 35-36; SBC Opposition to Petition for Reconsideration, WC 04-313, at 19-20.

²¹⁰ *Id.*

IV THE BOCs' TERM AND VOLUME SPECIAL ACCESS CONTRACTS ARE ANTICOMPETITIVE

In their initial Comments, Joint CLECs focused on two types of term and volume discount provisions that BOCs use to leverage their market power, including their superior geographic footprint, for anticompetitive gains: term and volume discounts that require a customer to obtain similar services from a BOC on a region-wide basis or that place restrictions on the use of UNEs in order to obtain discounts.²¹¹ Other commenters voice similar concerns regarding the BOCs' discount plans and similar lock-up devices offered by them.²¹² The BOCs contend, however, that such offerings are reasonable. However, the reality is they are not and serve to constrain rather than foster competition. For the reasons discussed below, the BOCs' arguments are unsustainable and can be rejected quickly. In addressing the problems associated with these anticompetitive contracts, the Commission should consider reinitializing month-to-month special access rates at TELRIC based levels.

A. The BOCs Are Engaging In A Strategy Of Establishing Unreasonable Month-To-Month Prices For Special Access Services And Then Offering "Discounts" Only When Customers Agree To Anticompetitive Terms And Conditions

As a preliminary matter, none of the BOCs addressing the issue of term and volume discounts mention the use of restrictions on the use of UNEs. Clearly, any requirement that makes it unattractive for a carrier to exercise its rights to UNEs under the Act should be viewed with a great deal of skepticism by the Commission. Access to UNEs is a key part of the market-

²¹¹ Joint CLECs at 41-45.

²¹² See, e.g., AT&T at 6; Broadwing Comments at 28; WilTel Comments at 13-16; CompTel/ALTS *et al.* Comments at 11-20; .

opening provisions of the 1996 Act and the Commission should be embracing policies that encourage rather than discourage their use.

SBC and Verizon defend their region-wide requirements to be eligible for special access rate discounts.²¹³ Verizon claims that there is no requirement to take service from Verizon throughout the entire service area in order to get discounts.²¹⁴ Implicit in this statement, however, is an acknowledgment by Verizon that tying discounts to region-wide purchase commitments would impair purchasers of special access and have anticompetitive implications; otherwise, Verizon would have no reason to claim that it does not exploit its superior geographic reach.

SBC takes the approach that it is the major special access purchasers that have the market power to leverage their region-wide purchases into rate discounts from SBC.²¹⁵ SBC maintains that its customers leverage their buying power in highly competitive areas and product markets by extracting pricing concessions in areas that are less competitive.²¹⁶ Thus, to SBC there is no reason to conclude that geographic discounts favor LECs over their customers.²¹⁷ Whatever validity this argument may have had in the past, it certainly would be lost going forward, especially if the largest nationwide purchasers of special access services—MCI and AT&T—are assimilated into BOCs. What would be left is much smaller, more regionally concentrated

²¹³ SBC Comments at 57.

²¹⁴ Verizon Comments at 14.

²¹⁵ SBC Comments at 57.

²¹⁶ *Id.*

²¹⁷ *Id.*

customers of special access services that have no bargaining power comparable to the market power of the BOCs. For SBC to assert that its remaining customers have the ability to exploit bargaining power to demand concessions from SBC, that SBC is compelled to also offer to all other requesting parties, is difficult to believe. SBC's argument sounds suspiciously like an argument a monopolist seeking to dupe its regulators into relaxing their regulatory oversight would make.

As discussed elsewhere in these comments, the BOCs attempt to paint a rosy picture of competition in which the BOCs are compelled to offer term and volume discounts to keep up with other carriers offering local exchange services or face competitive losses. Such arguments wholly lack credibility when the BOCs are earning 54% returns on average among them in the special access services market. If competitive access service providers are not competing with the BOCs on price in a market with such returns, the level of competition cannot be particularly robust. The BOCs should be facing competition from multiple sides if the local exchange market were truly open: they would have to compete not only on product packages, service quality, and customer service, but also on price as some purchasers of special access products would undoubtedly choose to make their selection solely on cost.

SBC and Verizon further assert that term and volume discount plans are pro-competitive because they serve legitimate business objectives for LECs and come in response to competition.²¹⁸ But discount plans cannot be considered pro-competitive when all they do is attach onerous commitments onto a discount from an overpriced product. A purchaser is simply exchanging price for added commitment. A pure pro-competitive discount would be one that

²¹⁸ SBC Comments at 51-53; Verizon Comments at 12.

legitimately tied a reduction in price and an increase in commitment to some actual savings realized by the providing service for providing the party over the longer period. That is not the case here. Further, competition is not driving these term and volume discount offerings. As explained above, the market for special access products is not sufficiently competitive to force the BOCs into providing products that are attractive to purchasers. Those discounts are instead driven by anticompetitive efforts to increase barriers to entry. Significantly, even under these exclusionary contracts, the special access rates charged over the term of the contract are not always fixed. In fact, U.S. Telepacific reports that PacBell can still increase its rates under such contracts as it raises its optional pricing plan rates in its tariff. Thus, the BOCs' ability to squeeze more and more out of their customers is not curtailed by these contracts and further demonstrates that they are not pro-competitive.

Next, SBC and Verizon claim that purchasers of special access products are free to decline the term and volume discounts and that term and volume discount plans are wholly optional. To the contrary, if the alternative is excessive prices, purchasers (when faced with limited or no competitive alternatives) have very little option but to commit to minimum volumes and extended terms. The BOCs essentially coerce purchasers into term and volume commitments by keeping the rates for special access without the term and volume discounts at monopoly rates.

SBC also maintains that its "minimum annual revenue commitments" ("MARCs") are reasonable.²¹⁹ These "MARCs" require purchasers to maintain a certain level of purchases from SBC in order to earn a discount; any lapse below the MARC and all discounts are lost. These

²¹⁹ SBC Comments at 54 n.177.

MARCs are clearly anticompetitive because they place unreasonable burdens on purchasers not to take special access products from competitors. If purchasers have the flexibility to only purchase services in excess of the MARC from competitors, competitors have a significantly reduced opportunity to take business from the ILEC.

SBC attempts to defend its practices by saying its customers demand these term and volume commitments as offered by SBC.²²⁰ This argument is patently absurd because it is difficult to imagine a purchaser demanding that SBC offer it a discount that the purchaser not only loses, but also must repay to SBC, if the purchaser lapses in its commitment to buy products from SBC. It is almost as if SBC is saying its customers want the safety of knowing they will always have a fat check to write to SBC every month and they should be punished if they cut back on their spending one month. SBC also claims that the term and volume discounts it offers produce revenue stability for ILECs.²²¹ The Commission should keep in mind that this statement is being made by a telephone company with more than 95% of the market share.²²² It is difficult to imagine that a company with that much of a multi-billion dollar market with low elasticity of demand can even measure the microscopic marginal increase in revenue stability resulting from such onerous commitments from its purchasers. One has to wonder how SBC's revenues are less stable without the term and volume commitments, and whether simply making its products more

²²⁰ SBC Comments at 57.

²²¹ *Id.* at 56.

²²² T. Randolph Beard, George S. Ford, & Lawrence J. Spiwak, Phoenix Center Policy Paper Number 20: Quantity-Discount Contracts as a Barrier to Entry, at 2 (Nov. 2004) ("Phoenix Policy Paper No. 20") (provided in Attachment A hereto).

affordable to purchasers across the board without such commitments might not solve whatever revenue stability problems it might be facing.

BellSouth claims that its pricing structure is a rational approach to prices that are set in a competitive environment because customers that choose a month-to-month plan pay a higher price than those that commit to longer terms and/or volume discounts.²²³ Verizon asserts that as the market becomes increasingly competitive, there is a greater risk that customers will leave for other suppliers before the ILEC has recovered all of the up-front costs of providing service and that under these conditions, both ILECs and CLECs will seek to charge higher short-term rates in order to minimize the risk of stranded investment.²²⁴

What these BOCs fail to reveal is that if competitive providers attempt to deploy their own facilities in the current environment, they have far more risk of stranded investment than the BOCs. The BOCs normally rely on legacy copper and fiber facilities to provision their high-capacity services. If anything, all they need to do, as a general matter, is add or modify the electronics at the end of such previously deployed facilities. Moreover, because carriers are struggling to compete with the BOCs and because BOCs have increased their monthly special access rates to exorbitant levels that are well above economic forward-looking costs, carriers have no alternative but to enter into the BOCs' unlawful exclusionary term and volume optional pricing plans so that they can avoid such unreasonable month-to-month charges. While BOCs' contend that average per unit revenue is decreasing, the truth of the matter is that prices for DS1 and DS3 special access services are not decreasing for both month-to-month and optional pricing

²²³ BellSouth Comments at 19.

²²⁴ Verizon Comments at 22.

plans but rather increasing. The reduction in per unit revenues noted by the BOCs only demonstrates that they have been successful in using their rate increases to lock up CLECs in such exclusionary contracts that allow the BOCs to control demand, exercise market power, and make competitive facilities-based deployment practically infeasible.

It is clear that the BOCs are engaging in a strategy of establishing unreasonable month-to-month special access prices and then offering “discounts” only when customers agree to anticompetitive terms and conditions. Because of their incredible market power, BOCs lock purchasers into term and volume commitments that keep them from seeking alternative products from competitors. Although Verizon proposes that the Commission permit LECs to enter individually negotiated agreements outside the scope of current rules, for all access services throughout their serving territories,²²⁵ the Commission should reject its request and other similar requests because granting them would spur further anticompetitive contracts.

B. The BOCs’ Anticompetitive Contractual Requirements Are A Barrier To Entry and Should Be Eliminated By Reinitializing Month-To-Month Special Access Rates At UNE Rate Levels

Because the BOCs’ basic instinct is to defend their dominant market power under the current regulatory regime, the BOCs’ behavior is not surprising or unexpected. Aghion and Bolton’s 1987 paper entitled *Contracts as a Barrier to Entry*, published in the American Economic Review found that “an incumbent seller who faces a threat of entry into his or her market will sign long-term contracts that prevent the entry of some lower-cost producers (at 388).” The Phoenix Policy Paper No. 20 further demonstrates that such contracts between the buyer and seller can deter efficient entry and such contracts are, consequently, socially

²²⁵ Verizon Comments at 34.

inefficient. The Phoenix Paper shows that such contracts *reduce social welfare by deterring efficient entry*. The fact that quantity discounts deter not only entry, but *efficient* entry, is extremely important to consider in determining correct telecom policy.

The Phoenix Policy Paper proposes “solutions to the entry-detering nature of the Special Access contracts including, obviously, regulations restricting the terms of such contracts most conducive to entry deterrence.” As the Policy Paper notes, “[t]he most pernicious term of such contracts is quantity-based discounts linked to large penalties, either a direct payment or higher average prices, for the failure to meet the specified quantity due to a migration to a competitive vendor or to unbundled network elements.”²²⁶ However, “the administrative costs of an effort to regulate the specific terms and conditions of Special Access contracts may be high, and care must be taken, in establishing and implanting regulations, not to rob buyers of price discounts applied to what appears to be monopoly prices for Special Access services.”²²⁷

The Phoenix No. 20 Policy Paper proposes an alternative and perhaps a more effective and efficient solution.

Specifically, *the entry-detering efficacy of the contracts can be eliminated if high-capacity circuits are made available on a wholesale basis at cost-based prices (e.g., TELRIC) without use restrictions historically applied to such access*. A cost-based price for wholesale high-capacity circuits encourages efficient entry, and nullifies the potential entry-detering effects of long-term quantity-discount contracts. As such, [the Paper] demonstrates that a pro-entry public policy would not only seek to reduce anticompetitive contractual provisions, but also ensure that high-capacity circuits are made available on a wholesale basis at cost-based rates, the latter perhaps being a more effective and lower risk solution than the former.²²⁸

²²⁶ Phoenix Policy Paper No. 20 at 4..

²²⁷ Phoenix Policy Paper No. 20 at 4..

²²⁸ Phoenix Policy Paper No. 20 at 4..

In their initial comments, Joint CLECs proposed that month-to-month special access rates be reinitialized and set at UNE rates.²²⁹ As the Phoenix Policy Paper recognizes and as explained in Joint CLECs' comments,²³⁰ this approach would be a readily administrated, efficient and effective manner by which the Commission could address, in part, the numerous problems that plague the current special access regulatory construct. Indeed, taking this approach would readily achieve at least one pro-competitive and pro-consumer objective: it would ensure that special access rates approximate rates that would exist if the special access marketplace were truly competitive. "To be sure, if the month-to-month rate were established in an effectively competitive market, the general availability of a lower contractual rate, even one that required a sizeable term and/or volume commitment, could not be considered to be harmful to competition."²³¹ Of course and as discussed in the Joint CLECs' comments, fresh look relief should be granted concurrently to ensure that the objectives of such rate re-initialization are not delayed. For these reasons, Joint CLECs urge the Commission to reset month-to-month special access rates consistent with the Joint CLECs' proposal.

²²⁹ Joint CLECs Comments at 17-22.

²³⁰ Phoenix Policy Paper No. 20 at 19-21.

²³¹ AT&T Reply Comments, RM 10593, Reply Declaration of Professors Janusz A. Ordover and Robert D. Willig, ¶ 9 (Jan. 23, 2003) (further explaining that carriers are "impelled to chose onerous term and exclusivity conditions because the alternative month-to-month rate is so high and there are no competitive viable alternatives in a vast majority of the relevant markets.")

**V THIS PROCEEDING MUST BE COMPLETED BEFORE ANY ACTIONS ARE
TAKEN ON THE SBC/AT&T AND VERIZON/MCI MERGERS**

Contrary to Qwest's request, the Commission must complete this proceeding before any action on the proposed mergers of SBC with AT&T and of Verizon with MCI, not the reverse.²³² Qwest is correct that the proposed mergers would, if approved, harm competition. However, for that reason, it would be a serious mistake for the Commission to grant the merger applications to any extent prior to revising its special access rules in ways that can help assure that all BOCs will be unable to continue unreasonable special access pricing and anticompetitive terms and conditions. Reinitializing prices at reasonable levels, establishing strengthened price cap and pricing flexibility rules, and prohibiting anticompetitive terms and conditions will assist in ameliorating certain harms from the mergers. Therefore, the Commission should take these steps in this proceeding prior to completing its review of the mergers. In reality, Qwest is hoping that the Commission will impose a few narrow conditions on the mergers and then, having obtained them, oppose any serious reform of special access regulation in this proceeding.

Accordingly, the Commission should reject Qwest's position on this issue.

²³² Qwest Comments at 3.

VI CONCLUSION

The Commission should reform its rules governing special access pricing as recommended in these Reply Comments.

Respectfully submitted,

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ATTACHMENT A



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Phoenix Center Policy Paper Number 20:

Quantity-Discount Contracts as a Barrier to Entry

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George S. Ford, PhD
Lawrence J. Spiwak, Esq.

(November 2004)

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Phoenix Center Policy Paper No. 20

Quantity-Discount Contracts as a Barrier to Entry

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Abstract: This POLICY PAPER presents an economic model showing how incumbent local exchange carriers may deter efficient facilities-based entry for high capacity loop facilities through the use of quantity-discount contracts for Special Access services. Since efficient entry is deterred, these contracts are socially inefficient. The theoretical model also shows that the entry-detering effects of the contracts are eliminated if high-capacity circuits are made available at prices based on economic costs (e.g., TELRIC) and made available without use restrictions historically applied to such access. To foster efficient facilities-based entry, federal policies must address the entry-detering components of Special Access contracts and make high-capacity facilities available on an unbundled basis at cost-based prices.

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I. Introduction

Some believe that the largest corporate users of telecommunications services – the Enterprise market – have numerous facilities-based alternatives from which to buy telecommunications services because of their large expenditures on telecommunications services. Yet, market evidence reveals that the incumbent local exchange carriers (“ILECs”) continue to provide about 95% of the telecommunications facilities used to serve this sector.¹ Given the apparent richness of this market for facilities-based entry, an important question is why is there so little competition in the Enterprise sector?

There are, of course, many possible explanations for the lack of facilities-based entry. On the one hand, there are significant exogenous entry costs² inherent to the telecoms business. That is, the fact that Enterprise telecommunications expenditures may be large, and their demand may be concentrated, does not *a fortiori* mean that the Enterprise market is *economically suited* for facilities-based entry. As explained in more detail in Section II.A *infra*, even the FCC concedes that the structural characteristics inherent to the Enterprise market make entry difficult at best. While market density should improve the prospects for entry, density is not the only economic factor that limits the profitability of entry in telecommunications markets.

On the other hand, and as demonstrated herein, the incumbents have successfully stymied competitive facilities-based entry into the Enterprise sector by creating significant endogenous entry costs³ through a form of exclusionary

¹ For example, various public filings reveal that:

- Over 98% of AT&T’s local services for business customers of DS-1 level or higher are provided over ILEC special access services. *AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates For Interstate Special Access Services*, FCC Docket RM 10593 at 17; and
- Sprint reported that for just its long-distance segment (not including wireless) it “continues to rely upon the ILECs for approximately 93% of its total special access needs despite aggressive attempt to self-supply and to switch to CLEC-provided facilities wherever feasible.” *Comments of Sprint Corporation*, FCC Docket RM 10593 at 3.

² Exogenous entry barriers are fundamental characteristics of a market that attenuate entry (*e.g.*, sunk costs or scale economies) but are not influenced by the behavior of the incumbent(s).

³ Endogenous entry costs, alternately, are entry barriers that are created by the incumbent firm(s), and may include the enhancement of the exogenous barriers (*e.g.*, increasing advertising expenditures to increase the importance of scale economies). Level playing field laws are an

(Footnote Continued. . . .)

pricing structures incorporated into long-term contracts for high-capacity facilities in an effort to protect their monopoly power and rents. Properly designed, these contracts attenuate otherwise profitable entry as well as prevent competitive carriers from using more economically-priced Unbundled Network Elements (“UNEs”) for their high capacity access needs.⁴ Not surprisingly, several potential entrants and purchasers of high capacity facilities have complained that contracts for Special Access services have the effect of deterring entry, and we review some of these claims in Section II.B *infra*.

In light of these concerns, an important yet unanswered public policy question is whether or not contracts for Special Access services are designed to deter *efficient* entry, and thereby reduce social welfare. To address this question, we present an economic model in Section III *infra* that reveals how incumbent firms deter *efficient* facilities-based entry through the use of quantity-discount contracts. In the model, we show that both the incumbent and buyer of the Special Access service willingly sign the contract even though it deters efficient entry – that is, all firms behave rationally.⁵ Yet, *despite the fact that these contracts are entered into voluntarily, they reduce social welfare by deterring efficient entry*. Accordingly, the model’s finding that quantity discounts deter not only entry, but *efficient* entry, is extremely important to determine correct telecoms policy. The applicability of the model’s primary conclusion – *i.e.*, quantity-based discounts in contracts can be used to deter efficient entry – extends beyond

example of endogenous entry barriers. See Thomas W. Hazlett & George S. Ford, *The Fallacy of Regulatory Symmetry: An Economic Analysis of the ‘Level Playing Field’ in Cable TV Franchising Statutes*, 3 BUSINESS AND POLITICS 1 (2001) (available at: http://www.manhattan-institute.org/hazlett/the_fallacy_of_regulatory_symm.pdf).

⁴ Given the unattractive possibilities of stranding sunk costs, despite their protestations to the contrary, facilities-based entry is completely inapposite to the Bells’ self-interests. George S. Ford, *A Fox in the Hen House: An Evaluation of Bell Company Proposals to Eliminate their Monopoly Position in Local Telecommunications Markets*, PHOENIX CENTER POLICY PAPER NO. 15 (September 2002) (<http://www.phoenix-center.org/pcpp/PCPP15%20Final.pdf>).

⁵ *C.f.*, Oliver Williamson, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (The Free Press 1985) at 30 (“Transaction cost economics assumes that human agents are subject to bounded rationality, whence behavior is ‘*intendedly*’ rational, but only *limitedly* so’ and are given to opportunism, which is a condition of self-interest seeking with guile.”) (Emphasis in original and citations omitted.)

telecommunications, shedding new light on a component of exclusionary pricing behavior by incumbent firms.⁶

Solutions to the entry-detering nature of the Special Access contracts include, obviously, regulations restricting the terms of such contracts most conducive to entry deterrence. The most pernicious term of such contracts is quantity-based discounts linked to large penalties, either a direct payment or higher average prices, for the failure to meet the specified quantity due to a migration to a competitive vendor or to unbundled network elements. However, the administrative costs of an effort to regulate the specific terms and conditions of Special Access contracts may be high, and care must be taken not to rob buyers of price discounts applied to what appears to be monopoly prices for Special Access services.

The theoretical model suggests an alternative and perhaps more effective and efficient solution: Specifically, *the entry-detering efficacy of the contracts can be eliminated if high-capacity circuits are made available on a wholesale basis at cost-based prices (e.g., TELRIC) without use restrictions historically applied to such access.* A cost-based price for wholesale high-capacity circuits encourages efficient entry, and nullifies the potential entry-detering effects of long-term quantity-discount contracts. As such, the model demonstrates that a pro-entry public policy would not only seek to reduce anticompetitive contractual provisions, but also ensure that high-capacity circuits are made available on a wholesale basis at cost-based rates, the latter perhaps being a more effective and lower risk solution than the former. Importantly, for cost-based access to be an effective solution, buyers must be unconstrained either by contract or regulation in the conversion of Special Access circuits to unbundled elements (which are functionally equivalent but priced differently).⁷ Unbundled elements (or actual competitive alternatives)

⁶ See, e.g., John Temple Lang and Robert O'Donoghue, *Defining Legitimate Competition: How To Clarify Pricing Abuses Under Article 82 EC*, 26 FORDHAM INT'L L.J. 83 (November 2002); Russell A. Klingaman, *Predatory Pricing And Other Exclusionary Conduct In The Airline Industry: Is Antitrust Law The Solution?* 4 DEPAUL BUS. L.J. 281 (1992); Thomas A. Lambert, *Evaluating Bundled Discounts*, Unpublished Manuscript, Contracting and Organizations Research Institute - University of Missouri, Columbia (3 September 2004) (available at <http://cori.missouri.edu/pages/seminars/Lambert.pdf>) and citations therein.

⁷ The ILEC Special Access contracts can also limit the ability of a buyer to substitute unbundled elements for Special Access services. As noted by AT&T: "[E]ven if more broadly available alternatives [to Special Access] were to become available - e.g., if the Commission were to eliminate use restrictions on EELs or if broad-based facilities-based alternative were somehow to emerge - AT&T could not take advantage of them in many cases, because virtually all of these

(Footnote Continued. . . .)

must be available ubiquitously and without use limitations to eliminate the entry-detering nature of the Special Access contract.

The POLICY PAPER proceeds as follows: In the next section, a brief history of the issue is presented, including a description of two key entry barriers in the market for high-capacity circuits including contracts. Section III presents our theoretical model illustrating how quantity discount contracts can deter efficient entry. Conclusions and Policy Recommendations are provided in Section IV.

II. Entry Barriers for High-Capacity Circuits

As noted above, many believe that the largest corporate users of telecommunications services – members of the Enterprise market – have numerous facilities-based alternatives from which to buy telecommunications services. However, as the Commission itself conceded when it found national impairment for high-capacity loops in its *TRO*, entry barriers into this sector are extremely high and, as a result, the incumbents remain dominant providers of high-capacity telecommunications facilities.

As the Commission observed, the lack of entry in this market stems from two sources: (1) the inherent demand- and supply-side economics of the market and (2) strategic entry deterrence by incumbent firms.

A. Demand and Supply-Side Entry Barriers

From a demand perspective, for example, Enterprise market customers demand reliable services that include customized products, significant customer care, and enhanced security features. Moreover, they prefer a single provider capable of meeting all their needs at each of their business locations, which may be in multiple locations in different parts of the city, state or country. As a result, the economics of serving a particular enterprise customer at each of its business' facilities may be very different depending on the location of the facility.⁸

While the revenue commitment relative to the best-case cost of constructing a high-capacity loop facility may result in a positive profit margin for a particular

[Special Access Pricing] plans impose substantial penalties for early withdrawal, which would negate any savings. AT&T Petition, *supra* n. 1 at p. 22.

⁸ *TRO* at ¶ 302.

customer location, there are other obstacles that must be overcome before such competitive entry can effectively occur. These other barriers include the inability to obtain reasonable and timely access to the customer's premises both in laying the fiber to the location and getting it into the building thereafter, as well as convincing customers to accept the delays and uncertainty associated with deployment of alternative loop facilities.⁹ Constructing local loops in the best of circumstances generally takes between 6-9 months, yet delays nonetheless occur with great frequency and can impose significant additional costs. In some cases, construction can be delayed via protracted battles with municipal officials over the cost and right to dig up streets or other public rights-of-way to lay fiber. Similarly, obtaining building and zoning permits adds further delay as local authorities often conduct extensive inquiries into the planned construction activity of the competitive carrier. In some cases, local jurisdictions often impose construction moratoriums preventing the grant of a franchise agreement to construct new fiber facilities in public rights-of-way to appease political pressure regarding traffic delays.¹⁰

There also is the thorny issue of building access to multi-unit premises. As the Commission noted in its *TRO*:

Although multi-unit premises could present substantial economic opportunities for competitors, if the entity or individual controlling access to the premises does not allow a competitor to reach its customer residing therein (or places unreasonable burdens on the competitive LEC as a condition of entry), the competitive LEC may be unable to serve its customer via its own facilities, even where a competitive carrier may be ready, willing, and otherwise able to self-deploy the loop.¹¹

⁹ *TRO* at ¶ 303; see also T. Randolph Beard, George S. Ford and Lawrence J. Spiwak, *Why ADCo? Why Now? An Economic Exploration into the Future Industry Structure for the "Last Mile" in Local Telecommunications Markets*, PHOENIX CENTER POLICY PAPER NO. 12 (November 2001) (<http://www.phoenix-center.org/pcpp/PCPP12.pdf>) and citations therein; reprinted in 54 FED. COM. L. J. 421 (May 2002) (<http://www.law.indiana.edu/fclj/pubs/v54/no3/spiwak.pdf>)

¹⁰ *TRO* at ¶ 304; PHOENIX CENTER POLICY PAPER NO. 12, *supra* n. 9, and citations therein *passim*.

¹¹ *TRO* at ¶ 305. But *c.f.*, *In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, FCC 04-248, ___ FCC Rcd ___, Order on Reconsideration (rel. 18 October 2004) at ¶ 13, where the FCC denied unbundled access for Fiber to the Curb ("FTTC")

(Footnote Continued. . . .)

So, while entry may very well be feasible from a best-case financial perspective, the inability to access the customer premise due to third-party intervention precludes entry altogether.

We have by no means exhausted the demand- and supply-side economic conditions that limit the prospects for facilities-based entry. However, these conditions are not the focus of this POLICY PAPER. Rather, our intent is to evaluate the influence of contracts on efficient entry, and we turn to that issue now.

B. *Contracts as Barriers to Entry*

Exacerbating the significant and inherent barriers to entry has been the incumbents' insistence on including exclusionary pricing structures into long-term contracts for high-capacity circuits. That is to say, in order to get relief from paying the incumbent what otherwise would be the monopoly price for Special Access services,¹² purchasers of Special Access service are typically required to accept significant long-term volume discount provisions and term requirements (usually 3-5 years).¹³ And, of course, these contracts also usually contain onerous penalties for failing to meet the contract's volume and term commitments.¹⁴ As the Commission observed in its *Special Access Pricing Flexibility Order*:

facilities serving multiple dwelling units on the ground that this policy would encourage the Bells to "further deploy fiber architectures necessary to deploy broadband services to the mass market, and the benefits of such deployment outweigh the limited impairment that competitive carriers face." (Emphasis supplied.)

¹² George Ford and Lawrence J. Spiwak, *Set It and Forget It? Market Power and the Consequences of Premature Deregulation in Telecommunications Markets*, PHOENIX CENTER POLICY PAPER No. 18 (July 2003)(<http://www.phoenix-center.org/pcpp/PCPP18.pdf>); to be reprinted in NYU JOURNAL OF LAW AND BUSINESS (forthcoming Spring 2005).

¹³ These discounts on the monopoly portion of the customers demand are often conditioned on choices for the competitive sensitive portion of demand (e.g., discounts on the customer's entire demand that require the customer to maintain fixed levels of spending with the ILEC; alternatively, discounts on the customer's entire demand that require the customer to transfer business from the competitive supplier. As a result, competitors arguably cannot compete for a portion of the customer's business, because it would have to give an enormous discount on this portion to offset the higher cost incurred by the customer on the balance of its business, which must surrender the discount. For a detailed presentation of the types of exclusionary pricing structures under discussion here, see *MCI Ex Parte*, RM No. 10593 (June 30, 2003) at 3, 4.

¹⁴ *Id.*

[a]n incumbent can forestall entry of potential customers by “locking up” large customers To the extent the incumbent can lock in the larger ... customers whose traffic would economically justify the constructions of new facilities, the incumbents can foreclose competition for the smaller customer as well.¹⁵

The purpose of these contracts is obvious to all parties. From the seller’s perspective, as Verizon’s Vice-Chairman and President Larry Babbio recently remarked on an investors’ call: “Our goal is to encourage carriers to use our networks, rather than build their own” because special access service to other “carriers generate about \$5.5 billion of high margin business for us.”¹⁶

¹⁵ *In re Access Charge Reform*, Fifth Report and Order and Further Notice of Proposed Rulemaking, ___ FCC Rcd ___, FCC 99-206 (rel. 27 Aug. 1999) at ¶79.

¹⁶ Thomson Street Events, Final Transcript, Q3 2004 Earnings Conference Call (28 October 2004) at 11 (emphasis supplied). Significantly, this same type of pattern emerged on the mass market side. For example, immediately after the D.C. Circuit eviscerated the FCC’s unbundling rules in *USTA II*, the FCC sought to have the various parties “engage in a period of good faith negotiations to arrive at commercially acceptable arrangements for the availability of unbundled network elements” such as switching immediately after the *USTA II* decision came down. http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-245631A1.pdf. Yet, rather than embrace various offers from CLECs who wanted to move away from UNE-P towards facilities-based competition, the Bells rejected these offers out of hand. See, e.g., *AT&T Proposes Limiting Phone Network Leasing*, REUTERS (29 April 2004). In contrast to the naïve expectations of FCC Commissioners and some in the Bush Administration, press reports revealed that the Bells never wanted the CLECs to deploy their own facilities, and, in fact, tried to force the CLECs to use the Bells’ embedded facilities exclusively. Indeed, both SBC and Verizon are requiring that CLECs use their networks for nearly all of the CLECs’ phone traffic, discouraging the CLECs from installing their own equipment and preventing them from leasing from other providers. As a result, the press reported that many talks with these incumbents died. James S. Granelli, *Bells Now Aim for Rivals to Use Gear*, LOS ANGELES TIMES (7 May 2004). For example, the WALL STREET JOURNAL reported that under the terms of SBC’s proposal to Talk America (a small company in Reston, Va., that sells bundled local and long-distance services), SBC would require Talk America to send 90% or more of its phone traffic to SBC’s network instead of using its own equipment and not enter similar agreements with rival phone networks. Anne Marie Squeo, *SBC Dispute Undermines Move Toward Local Phone Competition*, WALL STREET JOURNAL (6 May 2004). In the end, it seems the Bells preferred to keep CLECs’ captive because they earn more on UNE-P than they would on UNE-L and, therefore, according to some Wall Street analysts, “appear firm in their opposition to any UNE-L strategy” LEGG MASON WASHINGTON TELECOM & MEDIA INSIDER, *FCC Phase Out of UNE-P Not so Simple* (14 June 2004). See also, *A Fox in the Hen House*, *supra* n. 4.

From the buyer's end, AT&T Wireless ("AWS") – which used high-capacity circuits to connect its cell towers – argued to the Commission that in the absence of unbundled high-capacity loops at TELRIC:

[T]he only ability AWS has to mitigate special access costs is by entering into long-term volume commitments with the ILECs in order to obtain pricing discounts. By locking AWS into long-term commitments, the ILECs greatly constrict AWS's ability to avail itself of alternatives that may arise, and *create a disincentive to deploy alternatives facilities even where otherwise economically feasible*. AWS must constantly weigh the costs of the termination liability when assessing the feasibility of alternatives to ILEC facilities.¹⁷

Likewise, Sprint advised the Commission that:

The BOCs are the only providers that can offer that geographic and service scope. In an effort to get any discount on interstate special access services, the IXC's must sign up for these broad contracts. To meet the discount terms, the IXC's must leave most if not all of their services with the BOCs. The IXC's are thus obligated to the BOC [sic] services and cannot switch to a competitor, even in the unlikely event that one exists. *With the large IXC's locked into the BOC, and competitors locked out, there is no economic reason for a competitor to attempt to build facilities that would provide a competitive alternative to the BOC.*¹⁸

And, as MCI Communications observed:

[d]iscounts on the monopoly portion of a customer's demand are conditioned on choices for the competitive sensitive portion of demand. *CLEC[s] cannot compete for a portion of the customer's business, because it would have to give an enormous discount to offset the higher cost incurred by the customer, which must surrender the [] discount.*¹⁹

¹⁷ Comments of AT&T Wireless Services, Inc., RM No. 10593 (December 2, 2002) at 6 (emphasis supplied).

¹⁸ See Sprint Comments, *supra* n. 1 at 5 (emphasis supplied).

¹⁹ See MCI Comments, *supra* n. 13 (emphasis supplied).

Clearly, the buyers of the high-capacity circuits believe that Special Access contracts are deterring facilities-based entry.

From a theoretical perspective there are a number of unanswered questions regarding these apparent exclusionary pricing provisions in the Enterprise market. First, can these contracts deter efficient entry and, consequently, reduce social welfare? And, second, what remedies are available to attenuate the ILECs' exclusionary pricing strategies? In the next Section, we construct an analytical model to shed light on these important questions.

III. The Model

Our model is an extension of the one found in Aghion and Bolton's 1987 paper entitled *Contracts as a Barrier to Entry*, published in the AMERICAN ECONOMIC REVIEW.²⁰ In that paper, Aghion and Bolton present a formal theoretical model showing that "an incumbent seller who faces a threat of entry into his or her market will sign long-term contracts that prevent the entry of some lower-cost producers (at 388)." In this POLICY PAPER, we generalize the Aghion-Bolton model to include stylized "quantity discounts." As we show, the solution is related to that of Aghion and Bolton, in that we find that a quantity discount contract between the buyer and seller can deter efficient entry and such contracts are, consequently, socially inefficient. The result obtains even under the conditions that all participants are rational and none are fooled by strategic behavior or false signals. Like Aghion-Bolton, we find that the entry deterring contracts are privately profitable but socially inefficient even if all entry is not deterred.

In our model there are three primary participants: (1) the incumbent seller (S ; the ILEC); (2) the buyer (B ; the CLEC or enterprise end-user); and (3) the potential facilities-based entrant (E). In order to provide end-user services, B must purchase one unit of output from S or, if available, one unit from E . We have a two-period model, where in the first period a buyer and seller sign a contract or not, and a potential entrant enters or not. In the second period, Bertrand price competition occurs if there is entry.

²⁰ P. Aghion and P. Bolton, *Contracts as a Barrier to Entry*, 77 AMERICAN ECONOMIC REVIEW 388-401 (1987).

In order to evaluate the effects of quantity discounts on entry, we consider the case where B has demand for 2 units of the input, with value \$1 each. It is assumed that the buyer can extract all surpluses from its customers. The seller S is able to supply all the inputs needed by B and can produce 0, 1, or 2 units at \$0.50 each. For simplicity, we assume that there are no other costs. The entrant E knows its costs, c_e , before its entry decision; the other participants do not know c_e , but do know that c_e is uniformly distributed on the interval $[0, 1]$. The entrant E can only provide 1 of the 2 units needed by B , so one unit is provided as a monopoly by S .²¹

If there is no contract and no entry, then S sells 2 units to B for \$1 each for a profit of \$1 $[= 1 + 1 - \frac{1}{2} - \frac{1}{2}]$. The profits for both B and E are zero. If there is entry, then the price for the contested unit is $P = \max\{\frac{1}{2}, c_e\}$ and the price for the monopoly unit is \$1. If E is more efficient than S ($c_e < \frac{1}{2}$), then the profit for S is $\frac{1}{2}$, the profit for B is $\frac{1}{2}$, and the profit for E is $\frac{1}{2} - c_e$. Alternately, if E is less efficient than S ($c_e > \frac{1}{2}$), then profit for S is c_e , profit for B is $(1 - c_e)$, and profit for E is zero.

If there is some positive level of sunk-entry costs, then E enters only if the expected profit is positive ($\pi'_E > 0$). If there is no contract, entry occurs only if $c_e < \frac{1}{2}$, and the probability of entry is given by

$$\phi = Pr(c_e < \frac{1}{2}) = \frac{1}{2}. \quad (1)$$

From the discussion above, it follows that without a contract, the expected profit for S is

$$\pi'_S = (1 - \phi) \cdot 1 + \phi \cdot \frac{1}{2} = \frac{3}{4}, \quad (2)$$

and the expected profit for B is

$$\pi'_B = (1 - \phi) \cdot 0 + \phi \cdot \frac{1}{2} = \frac{1}{4}. \quad (3)$$

²¹ The entry deterring effects of BellSouth's "Fast Packet Option," where large discounts on high-capacity circuits are linked to purchases of BellSouth's frame relay services, can be illustrated using a similar model to that presented here.

Importantly, the buyer will not sign a contract that renders a profit less than $\frac{1}{4}$, since the expected profit without a contract is $\frac{1}{4}$. Similarly, the seller will not sign a contract that will reduce its profit below $\frac{3}{4}$. The task, then, is to show that the seller and the buyer will voluntarily sign a quantity discount contract that prevents entry, and they will do so only if their expected profits are at least as large as those computed in Eqs. (2) and (3).

Now, consider a simple quantity discount contract $t = (P_1, P_2)$, where P_1 is B 's payment to S for one unit and P_2 is B 's payment to S for two units. So, the marginal price of the second unit is $P_2 - P_1$. The buyer will purchase the second unit from E only if the entrant's price is less than the marginal price of the second unit from S . Call this price \tilde{P} , which must obey the constraint $\tilde{P} \leq P_2 - P_1$.²²

In the presence of this contract, the entrant enters with probability

$$\phi' = \max\{0, P_2 - P_1\}. \quad (4)$$

The buyer will sign the contract t only if $P_2 \leq \frac{7}{4}$ (so that B 's profit is at least $\frac{1}{4}$). The optimal contract solves

$$\phi' = (P_1 - \frac{1}{2}) + (1 - \phi')(P_2 - 1) \quad \text{s.t. } P_2 \leq \frac{7}{4}. \quad (5)$$

The solution to the optimal contract is $(P_2^* = \frac{7}{4}, P_1^* = \frac{6}{4})$, where the marginal price of the second unit, \tilde{P} , is only $\frac{1}{4}$. Note that the price for one unit under the contract substantially exceeds the price without the contract. This price difference $(\frac{7}{4} - 1)$ represents a penalty on B for defecting to the entrant.

Under the contract, the expected profit to the seller is

$$\pi_S^t = \frac{3}{4} + \frac{1}{16}, \quad (7)$$

which is a higher expected profit than without the contract. The expected profit to the buyer with the contract is

$$\pi_B' = \frac{1}{4}. \quad (8)$$

²² If the entrant's price does not satisfy this constraint, then B 's profit would be less than $\frac{1}{4}$.

So, the buyer will also sign the contract since its expected profit is unchanged.

What is the effect of the quantity discount contract t between the buyer and seller? With a marginal price of the second unit being $\frac{1}{4}$ under the contract, the entrant will not enter unless $c_e < \frac{1}{4}$, which occurs with probability $\frac{1}{4}$. Without the contract, the probability of entry was $\frac{1}{2}$. Thus, the contract reduces the probability of entry. Importantly, quantity discount contract deters *efficient* entry (entrants with cost, $\frac{1}{4} < c_e < \frac{1}{2}$), and therefore reduces social welfare.

Now, consider a scenario where the incumbent is required to offer its output at a cost-based rate of $\frac{1}{2}$ per unit (*i.e.*, cost-based pricing of unbundled elements). Is there a contract that both the seller and buyer will sign that will deter efficient entry? The answer is *no*. With cost-based pricing, there is no entry-detering contract that the seller is willing to sign (that is, it is profitable). Thus, an unbundling regime with cost-based prices eliminates the ability of the seller to use a contract to deter efficient entry.

IV. Conclusions and Policy Implications

A number of important policy conclusions can be drawn from the preceding analysis. First, the quantity-discount contract reduces entry even though the entrant may be more efficient than the incumbent. Since the contract keeps out more efficient entrants, the contract is *socially inefficient*, even though the contract is privately beneficial to both firms. In essence, the contract is an agreement between the seller and buyer to expropriate some gains that might accrue to the customers of the buyer (*i.e.*, end users) due to entry by a more efficient entrant. It is this expropriation of potential gains to end users that make the mutually beneficial contract possible.

A second and very important policy implication of the model relates to wholesale access to high capacity facilities. It is clear from the model that requiring the ILECs to sell high-capacity circuits on a wholesale basis at economic cost can eliminate the entry deterring effects of the contract by making entry-detering contracts unprofitable. With cost-based access, entry occurs if and only if it is efficient, and efficient entry is not deterred. Thus, in the context of high capacity circuits, the theory indicates that circuits should be made available to CLECs at cost-based rates (*e.g.*, TELRIC).

The analysis also suggests that for cost-based access to provide an effective solution to entry deterrence effectuated through Special Access quantity-discount contracts, the cost-based access must be without use restrictions historically applied to the facilities.²³ These anticompetitive use restrictions – which relate primarily to the mix of traffic carried over the circuit – have rendered the wholesale, cost-based access a worthless alternative to Special Access services. For example, the competitive carrier PaeTec observed:

[T]he co-mingling and use restrictions applicable to conversion of special access circuits to UNE combinations render that cost based alternative for leasing the same facilities as economically and operationally impractical.²⁴

To ensure efficient entry is not deterred but encouraged, when the Commission mandates unbundling it should ensure that the facilities should be unbundled and made available at cost without regard to the use of the facility, including the mix of traffic carried over that facility. Use restrictions are unnecessarily regulatory and encourage inefficient entry decisions. The Commission now appears to recognize the inefficiency of use restrictions and, with the one narrow (though potentially dangerous) exception of limiting an ILEC's unbundling obligation to a total of two DS3s per requesting carrier to any single customer location, made high-capacity circuits available without use restrictions in the TRO.²⁵

As the Commission prepares to issue its next version of its unbundling rules, the Special Access case study presented herein serves as a “canary in the coal mine” regarding the design of effective pro-entry competition policy. Indeed, if there is no entry in a sector comprised exclusively of the largest carriers and customers in America, then there is a serious market failure present and, by extension, a failure of the Commission to establish effective pro-entry policies.

²³ The TRO eliminated such use restrictions, but as the D.C. Circuit eviscerated the FCC's unbundling rules *in toto* in *USTA II, United States Telecom Association v. FCC*, 359 F.3d 554 (D.C. Cir. 2004), how the Commission will approach this issue when it issues its next set of unbundling rules is unclear.

²⁴ *Comments of PaeTec Communications, Inc.*, RM No. 10593 (November 27, 2002) at 3.

²⁵ See TRO at ¶ 324.

As our theoretical model shows, even if firms can get over the significant sunk cost issue (a fundamental component of the impairment analysis requires under Section 251 of the Telecom Act²⁶), the Bells – through the use of quantity-discount contracts – still very much have the incentive and ability to stymie efficient entry. As a result, a pro-competition policy agenda must include unbundled network access to high capacity circuits and/or tighter regulatory control of Special Access pricing and contractual terms.

²⁶ George S. Ford, PHOENIX CENTER PERSPECTIVES NO. 04-05: *You're Not Impaired Because You Are Impaired* (10 November 2004) (<http://www.phoenix-center.org/perspectives/Perspective04-05Final.pdf>).